

9 June 2011

Memorandum Detailing the Pension Accord of 4 June 2010

1. Introduction

1.1 General

According to the experts, the Dutch pension system is among the best in the world. Nevertheless, from time to time it becomes necessary to adjust the system in order to reflect changing circumstances while preserving the most important features of this system. One such feature is the aim to achieve pension solidarity between the various groups of interested parties in an affordable and feasible way by making collective agreements at the decentralised level through long-term arrangements.

Striving to achieve pension solidarity has been a premise of the pension system for decades. Thanks to these efforts, as well as to a government that supports this objective with measures including tax facilities, the Netherlands' pension system has been able to become what it is today. The value of this system is acknowledged abroad as well.

There are many features of this system that make it something to be proud of, and to cherish, in part because of the enormous public importance of a well-functioning pension system for our society as a whole. That importance will only increase, both from a social and an economic perspective, when demographic changes arise.

At the same time, recent years have revealed that the Dutch pension system is vulnerable. The economic crises at the beginning of the millennium and in 2008/2009, as well as recent fluctuations in the long-term interest rates, have made that fact extremely clear. This has strengthened the conviction of the social partners that changes must be made to make our pension system 'resilient and flexible'. In other words: if we want to preserve the positive aspects of our pension system, we must be prepared to make adjustments to that system in a timely fashion. Only then will we be able to achieve our goal of 'a modern, qualitatively good and affordable pension for everyone'. The timely adjustment of the system is the only way to ensure that we justify the trust participants

have in that system.

The Netherlands has a wide-ranging and differentiated – and thus unique – pension system. It is a system worth our joint efforts to preserve the basic principles underlying it. The system comprises three pillars, the AOW (the state-funded old-age pension), occupational pensions and individual pensions. The following are the principal characteristics of occupational pensions:

- collectivity;
- solidarity;
- mandatory participation;
- mandatory coverage by industry pension funds;
- the structure of the operation and supervision of those funds;
- centralised pension negotiations and decision-making at the sector or company level;
- involvement by the social partners in pension fund operations.

Our pension system can only be sustained if employers and employees (the social partners) and the government continue to take responsibility for the system. For employers and employees, the negotiations regarding employment benefits is the forum for negotiating occupational pensions. The government will have to fulfil its share of the responsibility by continuing to promulgate consistent regulations geared to the results of these negotiations.

1.2 Specifics of the Pension Accord regarding second-pillar employment-related pension schemes

In the Pension Accord¹, the social partners set out the adjustments they agreed were necessary for occupational pensions in the second pillar and made related proposals for the future sustainability of the AOW in the first pillar. The social partners also agreed to develop a policy agenda to substantially improve the labour-market participation and mobility of older employees.

The most important agreements regarding the second-pillar pensions are as follows:

- The social partners want a future-proof system that can better withstand changes in life expectancy and developments on the financial markets, but which also has an improved indexation quality. The fundamental characteristics, such as collectivity, solidarity and mandatory participation, must be retained. A new balance must be found between ambition, certainty, solidarity and costs;
- More extensive automatic cost increases (for both employees and employers) must be avoided. Target pensions must from now on conform to the maximum contributions limit achieved in recent years and allowances must be made for exogenous developments regarding life expectancy and the financial markets. This will not affect the possibility for parties to collective bargaining agreements to make new choices between pension and other employment benefits within the ‘decentralised’ (i.e., at the sector or company level) overall employment benefits policy.

¹ *Pension Accord Spring 2010*; The Labour Foundation [*Stichting van de Arbeid*], 4 June 2010.

- Increasing life expectancy must be prevented from tacitly and stealthily raising target pensions. What is needed is a change from the current pension contract to one that will confer on future generations the right to the same number of pension years for the same number of accrual years.
- Pension contracts must be made resistant to shocks from the financial markets (interest, inflation, returns). Performance dependency is ‘for better or for worse’ (adapting to the volatility of the financial markets);
- Pension contracts must be as complete and transparent as possible, because the situation that must be avoided in which a gap is created between the target pension and pension expectations on the one hand and the future pension benefit in real terms on the other (gap prevention).

In the Pension Accord, the social partners agreed to meet again in the second half of 2010, along with the decentralised partners and the government, to discuss the specifics of implementing the agreements set out above.

Based on the specifics of the new pension contract, the social partners have made agreements with the government concerning the corresponding and necessary adjustment of the financial assessment framework [*Financieel Toetsingskader*] (‘FTK’), the Pensions Act and the Witteveen tax framework [*Witteveenkader*]. This Memorandum contains the specific details of the new pension contract. It is the product of intense discussions both within and outside the Labour Foundation².

Finally, the Labour Foundation was the site of intensive meetings between the social partners regarding the accompanying policy on older employees, which must focus on actually increasing their labour market participation and mobility in the coming years³.

In the Labour Foundation’s view, applying the specifics to individual pension funds will require both a uniform and more tailored approach. The current pension contract also has both uniform aspects (structure of the pension scheme) and tailored aspects (the various parameters of the scheme, differences in investment policies). The new contract should be as similar as possible across the various industries and enterprises in order to promote the implementation and social recognisability of the new pension contract, to reduce its complexity and to mitigate the mobility consequences. The Labour Foundation will consult the Pension Federation and the Dutch Association of Insurers [*Verbond van Verzekeraars*] in order to contribute to the smoothest possible implementation of the new pension contract in companies, sectors and professional groups⁴.

In the Sections that follow, the Labour Foundation discusses the premises for (Section 2) and main points of the contract reform (Section 3), the most important elements of the new contract (Section 4), the necessary adjustments to the FTK (Section 5), the problems associated with transferring pension entitlements that have already been accrued (Section 6) and the possibilities for guiding the balance between the target pension and

² We specifically acknowledge the contributions of the SER Pension Accord Sounding Board Group [*SER Klankbordgroep Uitwerking Pensioenakkoord*]. The Foundation was also very grateful to have had access to the provisional analyses of variations on the new pension contract provided by a number of pension fund implementing agencies as well as a number of financial and actuarial firms. The Foundation also extends its thanks to the Pension Federation [*Pensioenfederatie*].

³ Policy Agenda 2020: Investing in Participation and Employability.

⁴ The social partners will consult the pension insurers and the government regarding how the agreements made will actually be translated into directly insured pension schemes.

the associated risks (Section 7).

The Labour Foundation will make a thorough assessment of the experiences with the new contract five years after it is implemented.

1.3 Recommendation by the Labour Foundation

The Labour Foundation urges decentralised parties involved with second-pillar pension schemes to reach agreements regarding the content of a new pension contract and to do so based on the specifics set out below. Given the time necessary for preparing the legislation, the aspects of the new contract that are intended to bolster resistance to financial market shocks cannot enter into effect before 1 January 2013. The rest of the agreements in the Pension Accord, which this Memorandum details and which include those regarding contribution stabilisation and life expectancy, will remain in full force and effect even in the period prior to 2013.

2. Premises underlying the new pension contract

The specifics of the new pension contract set out below are, in accordance with the Pension Accord, based on the following premises:

- a realistic and income-based target pension based on a stable contribution and realistic, prudent parameters regarding the expected returns and income and price development, such that, from the outset, the target pension is consistent with the financing for that pension;
- a transparent link between the risk profile of the collective participants, the desired 'certainty' (in the sense of statistical ranges of the pension result to be expected, not in the sense of guarantees of certain financial results) and the investment policy and/or composition of the investment portfolio, such that there is also consistency between the composition of the investment portfolio and the pre-assessed balance between the chance of indexation and the risk of adjustments;
- a balanced allocation of risks such that the results of those risks materialising is fairly spread over all of the participants: the current and future participants as well as the deferred participants;
- a pension contract that is as complete as possible, such that the relevant parties can ascertain in advance who will be bearing the risks and how the risks of, in any case, [increased] life expectancy and volatile financial markets will be allocated according to the calculation and allocation rules contained in the contract;
- a pension contract that is transparent and that lends itself to being communicated, such that all relevant parties have sufficient opportunity to assess the consequences the pension scheme will have for their individual situations;
- a contract that offers pension scheme participants sufficient choices with regard to their individual retirement dates and the opportunities for additional saving (with due observance of the regulations regarding the demarcation of pension fund activities), which will enable participants to affect their individual pension result;

- designing the new pension contract such that no unnecessary obstacles arise with regard to integrating it with the pension entitlements that have already been accrued (minimising transition problems);
- implementation of the pension contract by a collective pension fund or by an insurer, based on solidarity, average contribution or actuarial contribution and uniform accrual;
- structuring the new pension as similarly as possible across the various industries and enterprises; this will promote the ability to implement the pension contract as well as reduce its complexity and mitigate the mobility consequences. This will not affect the fact that the intended structure may also make allowances for industry- and fund-specific features⁵.

It would be logical for social partners to design and modify the new contract at the decentralised level, in which regard they may consult the pension fund board (the implementing agency) to arrive at a contract that harmonises the factors of target pension, contribution, investment policy and collective risk profile.

3. Main points of the contract reform

The *current pension contract* combines:

- a commitment that the nominal value of pensions and pension entitlements will only be reduced in exceptional situations;
- the intention to index the pensions and entitlements, which indexation is primarily conditional on the returns achieved.

The current contract is thus, as far as the result in real terms is concerned, a return-based contract. At the same time, the current contract is constrained, as it were, by the unconditional nominal commitment and the accompanying supervisory framework. As indicated in the Pension Accord, this hinders the achievement of the indexation target⁶, which has a negative effect on pension results. The contract has also proven insufficiently shock-proof with regard to financial market developments and makes no provision for adjustments in the face of ever-increasing life expectancies⁷.

Moreover, the Foundation notes that both the current and previous governments announced, based on the evaluation of the current FTK, that the supervisory requirements for the current type of contract would be made more stringent. The consequence is that the price of the current type of contract will be higher than it is now. This intended policy creates even more impetus for transitioning to a new pension contract⁸.

⁵ The effects on related legislation must also be examined. One particular point of attention is the relationship with the International Labour Organization (“ILO”) Convention that specifically applies to seafarers.

⁶ In this respect, please refer to the Appendix to the Pension Accord. The necessity of having to accrue insurance buffers, having to take into account a risk-free discount rate, the contribution instrument that no longer offers any solutions for financing equity shortfalls and the unsustainable schism between funds’ investment policies struggling to cover the nominal guarantee while achieving the real target.

⁷ The FTK in the current contract does not permit unconditional rights to be retroactively changed to take into account changes in life expectancy forecasts. Moreover, the current contract continues to be extremely susceptible to fluctuations in nominal interest rates through having to take pension commitments into account.

⁸ The government has established that the intended certainty of 97.5% cannot be achieved with the current FTK. If nominal guarantees are issued, the government wants certainty of at least 97.5% that pension funds will be able to achieve this. The government has therefore decided to make a number of stringent modifications to the current FTK. These are outlined in the letter dated 7 April 2010 from the Minister of Social Affairs and Employment [SZW] to the Lower House of the Dutch Parliament. The Labour Foundation was not consulted about these

The Labour Foundation would like a reformulated contract that is return-based, like the current contract, but that:

- ✓ is expressly aimed at achieving a realistic target⁹, but based on the understanding that pension results are largely dependent on investment results, making risks inherent;
- ✓ no longer contains unconditional nominal commitments, preventing the corresponding supervisory requirements from obstructing an affordable, realistic target; This will be expressed by the fact that pensions will no longer have to be based on a risk-free discount rate, but rather that the expected return on the portfolio can be used as the maximum basis for the discount rate;
- ✓ ensures that the selected degree of certainty, which is tailored to the participants' collective risk profile, is expressed in the composition of the investment portfolio *and* allows a sufficient amount of time to absorb shocks from the financial markets; the contract will thus continue to offer certainty (see also Section 7, which contains a much more detailed discussion of the relationship between target, risks and certainty);
- ✓ can absorb increases in life expectancy such that subsequent generations are treated equally by accruing the same pension entitlements over the same number of years, thereby preventing an automatic increase in the target pension.

The point of departure is an average-pay scheme with a salary-linked target pension and a price-related pension benefit. The pension entitlements that are accrued, as well as pension benefits, will be adjusted to correspond to new life-expectancy estimates and may, if the circumstances warrant it, be adjusted to reflect developments on the financial markets. These adjustments will be made based on the calculation and allocation rules stipulated in the pension contract.

This will remain a contract with a realistic target. However, the pensions in the new contract will profit from returns that are higher on average, although risks will be associated with those returns. This effect will be reinforced if the FTK for the current type of contract is made more stringent as announced by the government.

The effect the return factor has on pension financing has been significantly magnified by the maturing of the funds and the ageing of the workforce¹⁰. The pension results of the current contract are return-based, and those of the new contract will be as well. A significant issue, however, will be ensuring that the investment policy and the adjustment to reflect financial market developments are structured such that they can be

modifications at that time.

⁹ This can be achieved by combining a nominal target with a selected indexation target.

¹⁰ This has resulted in a sharp increase in the ratio of pension commitments to total salary costs. This factor will continue to increase in the coming years. The attempt to control contributions has become less and less effective and that effectiveness will continue to decrease. Moreover, contribution control designed to control entitlements that have already been accrued tends to swing upwards and downwards cyclically, which is jeopardising the solidarity between generations.

borne by the participants. The Labour Foundation thus considers it of paramount importance that conscious choices will be made, more than is currently the case, regarding the degree of index perspective, risks and certainty, as well as with regard to the corresponding investment policy. The certainty of achieving the agreed target pension will increase in proportion to the degree to which the risks in the investment policy are limited. Conversely, having an excessive portion of fixed-interest securities will put pressure on the investment results, which would decrease the inflation protection offered by the contract. The longer the period for absorbing financial market shocks, the better those shocks will be absorbed. This will have a positive effect on the pension result.

The Pension Accord also mentions the possibility of a hybrid contract. This type of contract would retain the current contract with an unconditional nominal commitment for a portion of the pension accrual. The government's position as guarantor would prompt it to formulate strict supervisory requirements with regard to the commitments made. Substantial pension sums would then be needed to protect that commitment, sums that would be withheld from the accrual of an inflation-proof pension. The Labour Foundation believes it would be wiser to refrain from guaranteeing unconditional commitments as part of this contract, as, in practice, these guarantees would be mostly illusory and would reduce the chances of indexation.

The Foundation wishes to create this certainty by harmonising the collective risk profile to the risk-bearing power of the participants and pensioners in relation to the target and the price of the contract, in conjunction with fair risk-allocation rules. This would limit the risk of pension rights being reduced while not significantly affecting the chances of pension indexation. The risk of nominal negative adjustments may be kept low, but that will mean a trade-off with the indexation prospects (see Section 7 and the appendix).

The Labour Foundation has considered whether the new pension contract can and should make a distinction according to age or accrual years. Making a distinction by age would make it possible to increase the level of certainty for the elderly and to prompt younger participants to focus more on a higher and riskier return profile.

After careful consideration, the Foundation has concluded that such a distinction would be susceptible to legal challenges, such as the pro rata accrual prescribed by the Pensions Act and the statutorily mandated equal treatment of employees regardless of age¹¹. The Foundation has also concluded that such a distinction would reduce the solidarity of pension schemes, which could have undesirable consequences for the compulsory participation in industrial pension funds.

The Foundation does consider it wise for a further study to be made of the usefulness and necessity, as well as the opportunities and consequences, of such a distinction in connection with the evaluation of the Accord and memorandum to be made five years after the new contract enters into effect. The Foundation requests that the Minister of Social Affairs and Employment consult the Foundation in taking the initiative to accomplish this.

¹¹ See the report of the Commission on the Future Sustainability of Supplemental Pension Schemes (Goudswaard Commission), 27 January 2010, Section 7.5.

4. The elements of the new contract

As noted above, there must from the outset be *consistency* between the target pension in real terms and the financing of this target through pension contributions and prudently estimated investment returns.

The most important elements of the new contract are:

- the contribution level that must be used as a premise pursuant to the agreements made in the Pension Accord (see Section 4.1);
- the return parameters used and the composition of a fund's investment portfolio (see Section 4.2);
- the contribution-exempt portion [*franchise*], accrual percentage and indexation of the pension entitlements accrued and the pension benefits. With regard to the latter, the issue is whether they will be indexed according to salary or price development or according to another standard derived from those figures. It will be up to the decentralised parties to stipulate their choice in the pension contract (see Section 4.3);
- the mechanism for making adjustments reflecting developments in life expectancy (see Section 4.4);
- the mechanism for processing shortfalls or excesses in coverage (see Section 4.5).

4.1 Contribution stabilisation

A provision in the Pension Accord stipulates that 'target pensions must from now on conform to the maximum contributions limit achieved in recent years and allowances must be made for exogenous developments regarding life expectancy and the financial markets (contribution stabilisation)¹². Please note that this 'will not affect the possibility for parties to collective bargaining agreements to alter the relationship between pensions and other employment benefits within their decentralised overall employment benefits policy'.

The stable pension contribution that is established for new pension accruals must be accompanied by a compatible, consistent target pension that is related to the composition of the investment portfolio, the return expected from that portfolio and the corresponding chances of indexation or adjustment (either positive or negative) to that return. Pension funds must inform participants and those who have accrued pension entitlements of the assumptions that have been made in this regard.

¹² Temporary recovery contributions and temporary pre-pension contributions from those years are not included in this central agreement on contribution stabilisation. The use of such contributions is a topic for decentralised employment benefit discussions. The existing sector-specific schemes or agreements regarding how this surplus will be spent will be respected.

Contribution adjustments will no longer be part of the mechanism used to absorb changes in life expectancy or financial market shocks. Section 4.4 of this Memorandum describes the adjustment mechanism to be included in the pension contracts for processing developments in life expectancy. Based on this, contributions will no longer be adjusted, either automatically or otherwise, for future developments in life expectancy. Contribution stabilisation relating to developments on the financial markets also requires a new adjustment mechanism for processing shortfalls and excesses in coverage in pension entitlements accrued. This Memorandum provides that (save for an equalisation reserve to be maintained) both shortfalls and excesses will be processed in a period of no more than 10 years by adjusting pension entitlements and pensions that have already begun paying out ('active pensions') (see Section 4.5). The new adjustment mechanism will become part of the contract when the contract is renewed. The current methods of processing shortfalls and excesses, such as obligations to make additional contributions, recovery contributions and contribution discounts, will thus become obsolete. Naturally, the conditions of this transition will be part of the decentralised negotiations.

The above will not affect the possibility for decentralised parties to make new structural choices in the future as regards the relationship between the occupational pension and other employment benefits within their decentralised overall employment benefits policy. This may be initiated by both employers and employees. Examples would be unforeseen circumstances with long-term consequences (either positive or negative) affecting the sustainability of the contract and the link between the contribution, expected returns and pension accrual¹³ or circumstances resulting from the financial position of the company or sector. If, as a result of this, there is reason to adjust the pension contribution for new pension accruals, this issue will be dealt with in decentralised employment benefits negotiations.

4.2 Return parameters and investment policies

The new, conditional pension contract must devote specific attention to pension funds' investment policies. After all, the degree of certainty will no longer be determined by nominal guarantees, but will have to be ensured by the combined totality of the risk profile, the composition of the investment portfolio and the manner in which the accrual of reserves is structured. This will require much better communication about the choices to be made regarding the risk-to-return ratios. A relationship must be established with the formulated target pension, the composition of the participant pool (age, income, etc.) and the expected return parameters, also taking into account the possibility of extremely volatile developments. The Labour Foundation recommends an approach that makes investment windfalls more likely than setbacks.

Given that no unconditional commitments will be made in the new contract, the risk-free interest rate – which must be used as the discount rate for valuing the pension commitments and the coverage ratio in the current contract – will become obsolete. The maximum discount rate value in the new contract may correspond to no more than the expected average long-term return and the inherent risks that are collectively taken in financing the pension. That is a significant improvement over the current situation. If a lower discount rate value is chosen, it would be advisable to use a valuation standard

¹³ The Labour Foundation recommends that expected returns be dealt with prudently and that the maximum return parameters used be based on long-term return achievements. This will promote the stability of the system.

that would be sufficiently stable over the long term. This can aid in avoiding the current problem with the decreasing interest-swap curve. In a more nominally structured variant, the choice might also be made to continue to base the discount rate on a risk-free market interest rate.

4.3 Contribution-exempt portion, accrual percentage and indexation

The Labour Foundation – in line with the adjustment to the AOW to reflect earned incomes – recommends as a sustainable guideline that the contribution-exempt portion of the pension schemes also be adjusted to reflect increasing earned incomes.

The accrual percentage and indexation standard are crucial elements for determining the target pension. The choice of an indexation target must be made by decentralised parties, on a scheme-by-scheme basis and must be explained and communicated in advance. One aspect of this might be an indexation according to salary development for pension accrual and according to price development for the pension benefits.

4.4 The adjustment mechanism for life expectancy changes

In the Pension Accord the social partners cited as one of the primary problems of the current system the fact that, with life expectancies increasing, the failure to change policy would lead to an implicit increase of the number of pension years while the number of accrual years would remain the same. To prevent this, the current pension contract must be ‘changed to one that will confer on future generations the right to the same number of pension years for the same number of accrual years’ (page 4 of the Pension Accord). The social partners also stated in the Pension accord that ‘the contribution-neutral incorporation of increased life expectancy must be accomplished based on a fund-specific situation. Cost savings may be used on an industry-by-industry or company-by-company basis to increase funds’ shock resistance, to improve the indexation quality or for extra pension accrual. The pension-calculation age and the AOW age must be harmonised with one another’. (See pages 4 and 5 of the Pension Accord.)

The adjustment accounting for increased life expectancies can also be structured so that participants will not have to continue working for the exact same amount of time as the increase in question. As the Pension Accord indicates, if life expectancy increases by one year, the same target pension may be achieved by working six to eight months longer.

The new pension contract must include an adjustment mechanism for absorbing changes in life expectancy. The social partners identify two elements:

- an adjustment mechanism for new pension accrual; and
- an adjustment mechanism for the existing entitlements under the new contract.

A The adjustment of pension accrual to reflect increased life expectancies

This adjustment comprises three components:

- a) The pension-calculation age will continue to be uniformly harmonised with the AOW age. Simultaneously with the statutory raising of the AOW age in 2020 to 66 years, the pension-calculation age for new

pension accruals in the second pillar will be raised to 66 years as of 1 January 2012. Upon the announcement and establishment in 2015 of the AOW age for 2025, the pension-calculation age will be raised to the new AOW age, probably 67 years, in 2015. Another adjustment of the pension-calculation age may be made if the AOW age is raised again after 2015 (every five years, thus first in 2020 for 2030).

- b) Adjustment to the amended survival tables. The cost consequences will be balanced against the costs saved by having a higher pension-calculation age. The adjustment to the survival tables will be made once every five years based on the authorised data regarding the development in life expectancies. The recently adjusted survival tables will be adjusted for the first time to reflect the most recent data in 2014, so that any adjustment made may enter into effect as of 1 January 2015.

It would be advisable, when the new contract begins being applied (2012) to completely factor in the recent adjustment to life expectancy based on the new survival tables published by the Actuarial Society [*Actuarieel Genootschap*] for 2010-2060 or the life expectancy statistics published by Statistics Netherlands [*CBS*]¹⁴, taking into account any temporary measures implemented earlier.

- c) Rule on contribution neutrality¹⁵: the balance of the costs of a) and b) will be processed by each sector or company such that they are contribution neutral:
- if there is a net cost increase, this will be adjusted by applying a negative ‘adjustment factor for life expectancy’ to the pension accrual in real terms (‘real pension accrual’) starting on the date that the net cost increase is processed: the accrual percentage and/or the indexation of the pension accrual will be discounted;
 - if there is a net cost-reduction effect, it will be reserved for the participants. This cost benefit will be distributed to the participants by applying a ‘life expectancy adjustment factor’ to the real pension accrual with effect from the date that the net cost reduction is processed: the accrual percentage and/or the indexation of the pension accrual will be increased.

Decentralised partners may also elect to use the cost benefit to improve the scheme or to increase the scheme’s resistance to shocks (by adding to the equalisation reserve (see Section 4.5)).

B The adjustment of existing entitlements under the new contract to reflect increasing life expectancies

In Section 2.5 of the Pension Accord, the social partners indicated that work must be done to form a solid financial basis for the entitlements that have been accrued. This means that the new contract will have to contain an adjustment mechanism in order to

¹⁴ The Labour Foundation believes it would be favourable to make the life expectancy-related adjustments every five years based on a single authorised data set.

¹⁵ The Witteveen tax framework must respect the consequences of applying the rule on contribution neutrality.

compensate for the cost increases that increasing life expectancies will mean for the pension entitlements under the new contract. These cost increases will occur when the survival tables are adjusted¹⁶. If the adjustment to the survival tables every five years results in a cost increase relating to the entitlements accrued up to that time, the compensation for those increases will have to be made out of pension entitlements and pension benefits. This cost increase must be recouped within a period of no more than 10 years by adjusting the indexation of the pension entitlements and pension benefits downwards for ten years, recording it as an ‘life expectancy adjustment for accrued entitlements’.

It is important to note that the application of this adjustment mechanism for the existing entitlements under the new contract is separate from the fund’s coverage ratio, but relates only to changes in life expectancy. The mechanism may thus also be triggered if a fund is not undercovered.

4.5 *Adjustment mechanism for absorbing financial shocks*

The pension accrual achieved is conditional and may be adjusted if developments on the financial markets prompt such action. These adjustments will be made if there is a coverage shortfall or excess (taking into account the equalisation reserve described below).

This mechanism may be structured in two different ways: based on a coverage ratio in real terms (*real coverage ratio structure*) or based on a nominal coverage ratio (*nominal coverage ratio structure*).

Real coverage ratio structure

In a real coverage ratio structure, there is considered to be a shortfall in coverage if the real coverage (after adjusting the pension accrual and benefits in accordance with the selected indexation criterion) is less than 100%.

The pension accrual and pension benefit payments will then be decreased (as of 1 January) so that real coverage of at least 100% is achieved. The adjustment of the pension accrual and pension benefit payments are made uniformly (no differentiation according to age), but can be spread over a period of no more than 10 years¹⁷. During that maximum period of 10 years, the indexation may be reduced by a uniform percentage, which in certain cases may also make the indexation negative (reduction of entitlements).

The long period of the spread ensures that financial shocks will be absorbed (partly by offsetting one another) and will also have positive consequences for pensioners, who will be afforded the opportunity to adjust their spending pattern to account for the new pension level. Adjusting pension commitments in combination with a real coverage of 100% means that no bills will be shoved off onto future participants; the current participants will divide the shortfall amongst themselves. This makes a long adjustment

¹⁶ The most recent adjustment by the Actuarial Society resulted in a cost increase for existing rights amounting to an average of 7%, or more than EUR 50 billion in macroeconomic terms.

¹⁷ In balance sheet terms (taking into account all discounts during the period of the spread), this brings the coverage ratio immediately back up to 100%. In ‘cash terms’ (based on the discounts actually processed), because of the period of the spread, the coverage ratio is brought back up to 100% over a period of no more than 10 years.

period of no more than 10 years a responsible option and increases the controllability of the pension scheme. It must also be kept in mind that this situation involves adjusting the *real coverage ratio*.

This can also be indicated through a (real) indexation scale. This scale can be structured such that it minimises the chance of a negative adjustment. That scale will decrease faster for lower degrees of coverage and increase slower for higher degrees of coverage.

The Labour Foundation recommends that the recovery to a coverage ratio of 100% (by discounting the indexation) be fully borne by a fund's existing participants on the date on which the undercoverage arises. In addition, the Foundation advises that the resulting indexation adjustment be passed on to new participants. This will invoke the solidarity of the new participants, who will be contributing to the accrual of an equalisation reserve rather than making up for the undercoverage¹⁸.

Nominal coverage ratio structure

An alternative for structuring the new conditional pension contract could involve a nominal contribution with an indexation scale based on the nominal coverage ratio.

With a nominal coverage ratio that corresponds to the capital required, full indexation is possible¹⁹. Under this level, an indexation scale will be used so that the shortfall will be recovered within a period of no more than 10 years. In the case of a coverage shortfall (nominal coverage ratio under 100%), the scale will be structured such that the nominal coverage ratio is brought back up to 100% within a period of no more than five years.

In the case of a nominal coverage ratio that exceeds the amount of capital needed, it would be advisable to form an equalisation reserve. The financial leeway above that amount can be utilised by extra indexation and/or allocating recovery indexations over a period of 10 years.

Equalisation reserve

In the Labour Foundation's view, it would be advisable to work with equalisation reserves. An equalisation reserve as meant here would be a reserve in addition to the real coverage ratio of 100% or in addition to the nominal coverage ratio with full indexation, with that reserve intended to absorb financial market shocks. Good returns can then be reserved for times when returns are below average. A portion of the contributions may also be earmarked for the accrual of an equalisation reserve. The utilisation of an indexation scale may also take into account any equalisation reserve that is to be formed. In that case, full indexation will first be possible at the level of the real coverage ratio, including the equalisation reserve.

It is expressly noted that the equalisation reserve is not intended to absorb the financial consequences of longer life expectancies (see Section 4.4).

The maximum amount of the equalisation reserve will be agreed at the decentralised level, in accordance with the composition of the participant base, the risk profile of the investment portfolio and the target maximum range of indexation volatility²⁰. The

¹⁸ This issue will not arise if the choice is made to use an indexation scale.

¹⁹ The amount of capital required is ascertained using the standard FTK2 method.

²⁰ In the context of the rules the social partners have provided in the contract, the making of withdrawals from and

Foundation advises that the amount of the equalisation reserve not be set too low, and that a ceiling amount also be established.

If the coverage ratio exceeds the equalisation reserve, then that surplus may be allocated to the participants, possibly taking earlier discounts into account. If an extra allocation is made from the surplus, it must be done in a uniform manner spread over a period of no more than 10 years. Another option would be to reduce the uncertainty regarding returns (see Section 7) by changing the composition of the investment portfolio.

5. A new financial assessment framework (FTK2)²¹ for a conditional actual or nominal pension contract

In line with the above, and in order to ensure that the supervision of the new contract is effective, the government must make agreements concerning the following issues:

- the structure of the feasibility test to be performed in advance: target pensions must from now on conform to the maximum contributions limit achieved in recent years and allowances must be made for exogenous developments regarding life expectancy and the financial markets;
- the adjustment mechanism for absorbing financial market shocks, which must be consistent with the contents of Section 4.5, including the maximum period of the spread to be agreed;
- the adjustment mechanism for life expectancy changes that must be triggered automatically in line with the contents of Section 4.4;
- stability in measuring the coverage ratio: the current volatility in measuring the coverage ratio must be avoided, perhaps by taking a more trend-based approach to the coverage ratio, partly as it relates to the position of market valuation in the new contract. The discount rate to be used in determining the coverage ratio in the FTK2 is relevant in this regard;
- the discount rate that is used to determine the coverage ratio (an element of FTK2); the risk-free interest rate will no longer be used as a standard for factoring in future rights. Instead, the expected portfolio return may serve as a maximum basis for the discount rate by taking a prudent approach to the applicable return parameters (and the composition of the fund's investment portfolio). For a coverage ratio that is expressed in real terms, the maximum discount rate will have to be adjusted for expected inflation. In this respect, the inflation standard is linked to the indexation choice set out in the scheme (salary inflation, price inflation or a mix of the two);
- rules must be drafted for realistic scenario analyses, which will provide individual participants with an understanding of the ranges within which the individual pension result will fall;

deposits into the equalisation reserve is the responsibility of the pension fund's board.

²¹ This new Financial Assessment Framework is referred to as FTK2 to distinguish it from the existing FTK in the current pension contract (FTK1) which – as the Minister of Social Affairs and Employment announced – will be adjusted in order that the degree of certainty of 97.5% can continue to be achieved under the old contract.

- a new procedure must be developed for establishing and revising the return parameters plus standard deviations, etc. The Labour Foundation's view is that these parameters must be re-established every five years. The Labour Foundation will consult the government about how the actualised parameters may be established. In this respect, the Foundation assumes that the parameters will only be adjusted if there are compelling reasons for doing so.

6. Transferring existing entitlements

Many of the pension entitlements that have been accrued up to this point under the current type of contract do not have a positive indexation perspective and continue to run the risk of being reduced. The new FTK requirements (FTK1) for unconditional entitlements will compel satisfaction with the currently applicable statutory certainty level of 97.5% for unconditional rights. That will mandate substantially higher buffers or an extremely defensive investment policy. Assuming a stabilised contribution, the prospects for indexation of the pension rights under the existing contract must be expected to worsen. The Labour Foundation thus considers it advisable to place existing entitlements under the aegis of the new contract. This will improve the indexation perspective of these entitlements. This entails that the existing entitlements will be made conditional, which means that, in the case of transfer, the valuation of existing rights will be accomplished by transitioning from the current risk-free discount rate to an discount rate that corresponds to a value of no more than the expected portfolio return. This will permit an investment policy with a clear indexation perspective.

The Labour Foundation realises that the transfer of existing entitlements implies a certain degree of retroactive effect. The Foundation is convinced, however, that continuing the current contract for pension entitlements that have already been accrued and active pensions will lead to lower net pension results than would be the case if these entitlements were converted into new entitlements based on the new conditional contract²².

Naturally, this would also mean that entitlements that are being transferred would be subject, for better or for worse, to the adjustment mechanism for absorbing financial shocks. The inflation resistance of the reformulated pension contract will thus improve, in line with the investment risks that can be spread under a collective contract. This exchange is one of the core issues associated with reformulating the pension contract.

The fact that the Labour Foundation is convinced that the new conditional contract will, on balance, lead to better results is exactly the reason that the Labour Foundation considers it advisable, from the perspective of the technical implementation of the contract, to have a statutory provision²³ enabling the existing rights to be converted into rights under the new pension contract on a pension fund-by-pension fund basis. Only if there were legal reasons precluding a statutory provision would the Foundation's view be that participants who have accrued pension entitlements under the schemes in which

²² The appendix to this Memorandum illustrates this point with several sample calculations.

²³ The Labour Foundation considers a collective transfer to be sound, from a legal perspective, as long as the average indexation quality of the existing rights is not worsened and as long as there is no chance that the participants will incur an excessive and substantial loss in comparison to the current contract. A framework of standards developed for this purpose would offer pension funds the necessary statutory guidance.

they are currently participating must be afforded the individual choice to place these entitlements under the aegis of the new conditional contract. In such event, the advantages and disadvantages of this choice would have to be outlined for the participants and pension beneficiaries in a balanced manner, in order to allow them to arrive at a responsible decision. They would have to be afforded an adequate term for taking a decision in this respect, and working based on a default approach would have to be considered.

7. Guidance based on target pension, risks and certainty

The current pension contract provides for indexation that is conditional on there being sufficient financial means available for such indexation. The latter factor is primarily dependent on the returns achieved. In that sense, the achievement of the target pension in real terms ('real target pension') in the current contract is dependent on the returns achieved. The new contract also makes indexation dependent on the returns achieved, but, under certain circumstances, it may also be related to a certain pension accrual achieved and the pension benefits, as explained in Section 4.5.

There are various tools that may be used to guide the balance between target pension and risk.

First, the target pension may be conservatively formulated by taking a prudent approach to the return parameters (average portfolio return). This will increase the chance of windfalls during the performance of the pension contract.

Second, a choice may be made to compose the investment portfolio in a particular manner. This determines the degree of risk that will be borne collectively. The composition of the investment portfolio may also be determined by the risk the scheme has chosen to run. This will have consequences not only for the ranges of pension results calculated in advance, but also for the susceptibility of the pension accrual and pension benefits to financial market developments. The riskier the investment mix, the greater the susceptibility.

Third, the choice may be made to maintain an equalisation reserve of a certain amount. Above-average returns may be 'squirreled away' in the equalisation reserve for times when yields are below average. The equalisation reserve would thus function as a sort of shock absorber, allowing the fund to forego immediately translating financial shocks into consequences for pension accrual and benefits.

Fourth, careful advance consideration may be given to the balance between the indexation perspective and the risk of deviating from that perspective, including the risk of a nominal negative adjustment. This may be accomplished, for example, through the structure of the scale described in the appendix.

Fifth, the Labour Foundation advocates a more trend-based approach to the coverage ratio. This will eliminate the need for a policy-based response to daily volatility on the financial markets and on the status of the coverage ratio based on certain fixed dates.

Sixth, if financial shocks must be translated into consequences for pension accrual and benefits, the adjustment for these shocks may be spread over a period of no more than 10

years. This will reduce the chance that an adjustment made in connection with a financial shock will exceed the indexation allocated in a particular year, which excess would result in a nominal downward adjustment.

Finally, it is noted that individuals may influence the balance between certainty and target pension. Individuals may save additional amounts during the active period and participate in the special leave scheme [*levensloopregeling*] and/or the vitality scheme [*vitaliteitsregeling*] envisaged by the government²⁴.

Social partners in businesses and sectors thus have a range of possibilities for guiding the balance between target pension, risk and certainty. Nominal prudence is an option, but so is real risk. The emphasis may be put on safeguarding the lower echelon, or by striving for upward potential. As long as the contract is suitable, as well as complete and transparent, for the participants.

With the current degrees of coverage, which have decreased precipitously, pension funds under the current contract would have to forego or restrict indexation for long periods of time in order to achieve the degree of certainty and the accompanying high buffer mandated by law.

The new conditional contract provides significantly more freedom than the current contract to determine the balance between target pension, risk and certainty. The appendix to this Memorandum elaborates on this feature.

Under the new contract, the decentralised parties may determine the risk profile in advance, by means of the pension fund's investment policy, thereby determining the probability of indexation (partial, full or more than full) as well as downward adjustments. These are advance probability forecasts, however, and offer no guarantee of the results. That is what distinguishes the new contract from the existing contract. The more emphasis the parties wish to place on indexation quality, the riskier the investment mix will have to be to increase the chances of indexation, but this would also entail greater chances ('for better or for worse') that there will have to be deviation (both upwards and downwards, including nominal discounts) from the indexation target. If, based on a certain investment mix, there is a wish to limit the chance of downward adjustments, the new conditional contract requires that an equalisation reserve be established for that purpose. As part of the agreed maximum contribution limit, a risk mark-up, which will be made available for the equalisation reserve, will be applied to new pension accrual. This also implies that employers would, by making their portion of the contributions, participate in forming a reserve for the reduction of the risks associated with the pension contract and the investments made to carry it out.

The Foundation considers it important that, when drafting the new contract, the decentralised parties be specific about their target for the probable indexation and the possible adjustments (including the chance of nominal discounts). This particularly regards the details and effect of the adjustment mechanisms described in Sections 4.4 and 4.5. For new pension accrual, there must from the outset be consistency between the

²⁴ The Labour Foundation's policy agenda on the promotion of labour market participation and mobility of older employees advocates that the vitality scheme, which is proposed in the government's coalition agreement and which is intended to replace the special leave scheme and the employee savings scheme [*sparloonregeling*], should continue to offer the option to spend the capital saved on a pension or pre-pension. As an alternative, perhaps the current special leave scheme and the related spending options should be maintained alongside the new vitality scheme.

maximum contribution limit available, the target pension, the choices made regarding the investment mix and the related risk profile, the expected return and the utilisation of maximum contribution limit for the formation of the equalisation reserve. It would be logical for the pension laws to prescribe that all of these elements must be communicated to the participants.

Appendix

Sample calculations: a comparison between continuing the current pension contract and transferring to the new pension contract

In its Memorandum, the Labour Foundation asserted its firm opinion that the continuation of the current contract for pension entitlements already accrued and active pensions would lead to an inferior pension result. This opinion is also based on the sample calculations that the Foundation had performed by Ortec Finance. This appendix outlines the results of those calculations.

The Foundation had a comparison made between continuing the existing entitlements in the current unconditional contract and transferring those entitlements to a conditional pension contract, premised on either a real coverage ratio ('really conditional') or on a nominal coverage ratio ('nominally conditional'). Calculations were made based on two variants of the real contract, specifically, one with a return-adjustment mechanism and one with a real indexation scale. The sample calculations are premised on an average fund in terms of age distribution with a current nominal coverage ratio of 107%²⁵ and an investment mix of 50% shares and 50% fixed-rate securities. The target level of indexation in all cases is a mix of 60% price inflation and 40% salary inflation, arriving at an indexation target of 2.4% a year. Both conditional contracts are premised on a 2% accrual of average pay per year, a pensionable age of 66 years and a stable contribution level²⁶. They also include an adjustment mechanism for absorbing financial shocks. In the nominal conditional contract this is accomplished with an indexation scale that restores, over a period of 10 years, the coverage ratio that makes full indexation possible. In the event of a coverage shortfall (coverage ratio under 100%), the scale takes the form of a discount that eliminates the coverage shortfall within five years. In the first variant of the real conditional contract, the adjustment mechanism is set up to eliminate coverage shortfalls within a period of 10 years. Both conditional contracts take into account an equalisation reserve of approximately 25%. In the case of a coverage ratio that exceeds the equalisation reserve, there is a real increase in the entitlements and pensions.

The second variant is based on the following scale:

- with a real coverage ratio of less than 85%, discount of one-tenth of the entitlements;
- with a real coverage ratio of less than 90%, no indexation;
- between 90% and 100%, real linear indexation;
- above 100%, real target indexation;
- real coverage ratio of over 130%, extra indexation of one-tenth.

The continuation of the existing entitlements under the current contract is premised on the assumption that a higher buffer requirement would apply in the context of an

²⁵ The calculation used a nominal coverage ratio of 110% and a nominal interest rate of 4%. Taking into account the partial coverage of the interest risk, this corresponds to a current coverage ratio of 107% with a market interest rate of 3.5%.

²⁶ This is based on 16%, of total salary expenses, which was the macro-average in recent years.

adjusted FTK1 in order to satisfy the statutory degree of certainty of 97.5%²⁷. An impact analysis performed by the Dutch Central Bank [DNB] (at the request of the Ministry of Social Affairs and Employment) shows that the increase of the buffer averages out at approximately 5 percentage points. The ultimate impact for an individual fund depends on the fund-specific risk profile. With the current low degrees of coverage, the certainty has dropped sharply. The 15-year long-term recovery plan under the current contract requires pension funds to demonstrate their ability to achieve the statutory degree of certainty of 97.5% and the corresponding nominal coverage ratio.

The table below summarises the results. The table expresses the chances of indexation ('equal to', 'greater than' or 'less than' the target) and the chance of 'nominal discounts'.

Table: Indexation perspective

	Current current accrual, pension contract (FTK1)			Nominal new contract, including transfer of old entitlements			Real conditional new contract, including transfer of old entitlements			Real conditional contract with scale 85%-90%-100%-130%		
	1-5 years	6-10	11-20	1-5 years	6-10	11-20	1-5 years	6-10	11-20	1-5 years	6-10	11-20
Median nominal coverage ratio (end of period)	125.5	134.3	147.0	124.5	128.7	133.0	119.1	124.5	128.6	119.8	126.6	133.5
Average chance of nominal discounts	0.8	0.3	0.1	4.3	1.6	2.1	6.8	4.7	4.0	5.9	2.7	2.4
Average nominal discount	3.1	4.1	3.0	0.9	1.0	1.3	0.8	1.2	1.1	0.5	0.5	0.6
Average chance of discounts in comparison with target index	88.8	66.0	47.2	71.7	49.3	42.7	41.6	29.9	24.8	47.5	29.3	20.7
Average chance of indexation = target index	1.6	8.3	24.9	9.4	21.0	24.0	56.1	55.6	44.5	51.6	64.0	59.9
Average chance of indexation > target index	9.5	25.7	27.9	19.0	29.7	33.3	2.3	14.5	30.7	0.9	6.6	19.4

Data originating from Ortec Finance

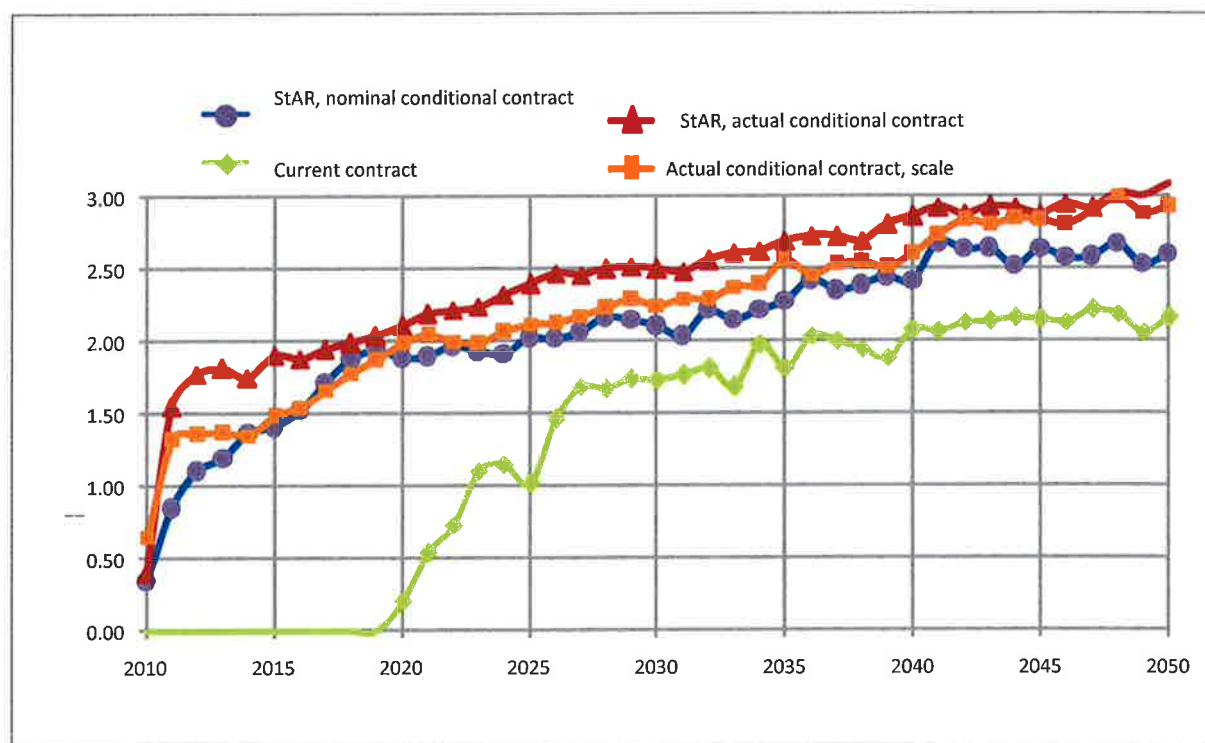
Continuation of current unconditional contract

The results of the calculations demonstrate that the indexation quality of the transferred entitlements would – in accordance with expectations – be consistently and substantially better than those of the current entitlements that would remain under the current scheme. This difference is the greatest in the 10-year period immediately following the implementation of the new system. This applies to both the substantially higher chance of discounts on the target indexation for entitlements remaining under the current contract and to the level of the expected pension result. Based on the current low

²⁷ The statutory degree of certainty under the current pension contract obliges funds to accrue buffers such that, in 97.5% of cases, shocks may be absorbed within one year without falling below the minimum threshold of the nominal coverage ratio of 100%.

coverage ratio, the current contract would require a long period of significant restrictions on the indexation target. This is because, before there is any possibility of resuming indexation, buffers must be accrued to restore the pension contract to its shock-proof condition under the statutory degree of certainty of 97.5%. As long as buffers must be accrued, indexation opportunities will be scarce. The figure below illustrates that, under the current contract, median indexation would have to be entirely foregone for a period of nearly 10 years. This implies a significant drop in purchasing power for pensioners and a real setback in pension accrual for active participants.

Development of median given indexation



Source: Ortec Finance

Comment: This comparison assumes the same amount of starting capital for each of the pension contracts.

Transfer to the new contract

The indexation perspectives under the new contract are substantially better. This contract no longer applies the statutory degree of certainty of 97.5%.

In this calculation, the item *nominal conditional contract* includes a chance of nominal discounts of approximately 2% starting with the fifth year²⁸. This is the flip side of the improved indexation perspective in comparison to the current contract. In this sample calculation, the nominal conditional contract is premised on using the nominal interest rate as a discount rate. This makes the calculation conservative and makes windfalls more likely than setbacks. This is expressed in the chance of nominal discounts, which

²⁸ The higher chance of nominal discount in the first five years of the conditional contracts relates to the low initial coverage ratio. This means that the certainty in the current contract remains far below the statutory certainty requirement of 97.5% (the actual degree of certainty is 85.7%). The data after the first five years is relevant for a structural comparison of the contracts. This notwithstanding, the differences in the initial period will have the greatest effect on the purchasing power of pensioners and the pension accrual of active participants.

consistently remains relatively low.

The *new contract on a real basis* differs, primarily in presentation and communication, from both variants of the nominal conditional contract. This contract is premised on the indexation target and discounts or mark-ups are communicated from the perspective of that target. In the nominal conditional contract, indexation is less clearly related to the indexation target. In real terms, this makes little difference. Nevertheless, the sample calculation shows differences in indexation perspective and chance of nominal discount in comparison to the nominal conditional contract. This is a consequence of the discount rate applied. The nominal conditional contract uses the nominal interest; the real conditional contract applies a riskier discount rate, that being the portfolio return²⁹. This results in the future entitlements having a lower value and improves the initial coverage ratio. This offers more leeway for indexation, but also increases the chance of nominal discounts. The chance of nominal discounts in the middle to long term is roughly twice as great as it would be in the nominal conditional contract. This chance nevertheless remains manageable (4%).

The variant with an indexation scale further reduces this chance by structuring the scale such that indexation is foregone entirely in the case of a real coverage ratio of 90% to 85%. Above 90% the real scale might approach 100%.

Conclusions

These sample calculations illustrate that, in comparison with the current unconditional nominal guarantee contract, the conditional contracts will be more successful in achieving the real target of the pension contract. As indicated in the Memorandum, there will also be multiple tools available to manage risks. The 10-year spread period aside, these tools include the discount rate to be applied (the more prudent the rate, the lower the risk of downward adjustment, at the cost of the upward potential in the indexation perspective) and the equalisation reserve. When making choices at the decentralised level in the conditional contracts, it is important to maintain a fair balance of the solidarity between generations.

²⁹ Using an investment mix of 50/50, this corresponds to a real discount rate of 3.1% (nominal portfolio return of 5.5%, less inflation of 2.4%).