

Pension Accord Spring 2010

4 June 2010

In this Pension Accord, the employers federations and trade union federations, the social partners forming the Labour Foundation [*Stichting van de Arbeid*], set out the adjustments they agree are necessary for occupational pensions in the second pillar, for which they bear particular responsibility. This Agreement also contains proposals regarding the future stability of the related state pension in the first pillar. The social partners believe that significant changes are necessary in order to safeguard the sustainability of the entire Dutch pension system. The two pillars of the Dutch pension system are coordinated and must remain compatible in the future. The proposals for the near future – to have both the state pension and occupational pensions reflect the fact that the average Dutch citizen is living longer and to offer more flexible retirement ages in both pillars, and thus also with regard to the state pension – will ensure this.

The reports of the Frijns and Goudswaard Commissions analyse the future development of occupational pensions in the second pillar. Both the social partners and the Cabinet¹ endorse the high lights of these analyses. The fundamental principles of our system – collectivity, solidarity and compulsory membership – must remain intact. But a new balance must be struck between aim, security, solidarity and costs. The crux of the issue comprises two essential problems.

First, an unchanged policy will see increased life expectancy lead to the implicit extension of the number of years during which subsequent generations will receive pension benefits. The resulting cost increase will become less and less sustainable.

Second, the current system of supplementary pensions is not sufficiently shockproof. For pension contracts providing for unconditional nominal benefits, the only remedies for negative developments on the financial markets (interest, inflation, low returns) are the non-indexation of pensions and accrued rights and, as a last resort (*ultimum remedium*), the nominal reduction of those rights. The contributions measure (a temporary increase in contributions) has always been ineffective in this regard, and will become even less effective as the population grows older. The pension expectations of current participants must continue to reflect both demographic developments and the reality of the financial markets.

The social partners intend to use this Pension Accord to align the pension system with the demands of the times. This will require significant changes. The changes will not only be technical in nature, but will also affect stakeholder behaviour, participant expectations, solidarity between those involved, the quality of information and transparency. The key points of the proposed changes are listed below.

¹ See the Cabinet's response dated 7 April 2010.

- More comprehensive automatic cost increases (for both employees and employers) in occupational pensions in the second pillar must be prevented. The objective is to adjust pension contracts – based on the presumption that the related contributions are stable and do cover costs – to take into account increased life expectancy and to be able to withstand negative developments on the financial markets. In this Pension Accord, the social partners set out the basic principles for a new, more transparent pension contract that takes into account developments in life expectancy and the financial markets. This will also require a customised financial assessment framework [*Financieel Toetsingskader*] (FTK).
- Participants' ambitions and expectations with regard to their pensions must be adjusted to reflect realistic financial possibilities so that they can be spared as many unpleasant surprises as possible.
- Solidarity will become even more vital to pension schemes. It will be made more explicit, and there will be more leeway for individual choice. The new pension contract must be transparent and as complete as possible, but it must also be easy to understand and feasible while keeping the costs as low as possible.
- The adjustments to the state pension in the first pillar and the occupational pension in the second pillar must be harmonised by having both take longer life expectancy into account. The state pension must also provide a more solid foundation for the system as a whole.
- The social partners emphasise the fact that the changes to the pension system must be accompanied by new measures necessary to ensure long-term employability and improve labour market mobility for older employees.
- The social partners trust that the government will facilitate this Accord. Additional consultation will be held if this appears not to be the case.

The social partners agree as follows regarding the state pension, second-pillar pensions and the labour market position of older individuals:

1. Regarding the state pension

In this *Pension Accord Spring 2010*, the social partners propose adjusting the state pension retirement age in the near future to reflect the increase in average life expectancy beyond the age of 65. In conjunction with this, the social partners also propose changing the state pension adjustment method by linking it to earned income in order to strengthen the first pillar in our country. This will bring an end to the long-term current situation, in which second-pillar pensions have had to effectively remedy the problems created by lagging state pension development. Having the first pillar of the Dutch pension system retain its relative position is also important to self-employed persons with no employees (ZZPs)², as well as to low-income individuals and early starters.

The social partners propose the following system for adjusting the state pension in light of increasing life expectancies:

- The average number of pension years for the generation who retired and received a state pension (with the macro average remaining life expectancy at 65) in the period between

² In this respect, please also see the advice that the Social Economic Council [*Sociaal-Economische Raad*] (SER) will soon be publishing regarding the position of ZZPs.

2000 and 2009 will be used as a reference period for linking the state pension age to increased life expectancy.

- The state pension age will be periodically adjusted, based on pre-agreed reference dates, to changes in the macro average remaining life expectancy at 65 in comparison to the 2000-2009 reference period.
- A change in the state pension age will be announced 10 years in advance and will be made every five years. This means that (assuming that each change will involve a maximum adjustment of 1 year) the first raise to 66 will enter into effect in 2020, and that the next step for 2025 will be agreed and announced in 2015. Based on our current understanding, the state pension age will have to be raised to 67 by 2025³.
- Flexibility can involve penalties or rewards; the pension of those opting for early retirement (retrospective flexibility) is offset by a 6½% reduction per year, while that of those who work after reaching retirement age (prospective flexibility) is offset by a 6½% increase per year⁴. Retrospective flexibility cannot extend below 65. In the case of early retirement, there will be no entitlement to the state pension if the state pension plus a supplementary pension would confer a right to social assistance benefit during the entire pension period.
- Beginning in 2011, the state pension will be linked to developments in earned income⁵. The budgetary consequences of this may be absorbed by a gradual restriction of old-age tax credits and the state pension supplement.⁶ In conjunction with this, and partly to alleviate the burden on the second pillar, the state pension offset in supplementary pension schemes will also be linked to the development of salary. This will have to be included in the Witteveen tax framework for supplementary pension schemes (see Section 2.4).
- The dismissal age will remain linked to the state pension age. In the context of the plan to be developed to improve the labour market position of older employees (see Section 3), this point may be subject to reconsideration in relation to the broader consideration of measures that will promote the employability of older employees.⁷

2. Regarding occupational pensions in the second pillar

2.1 Contribution stabilisation for supplementary pension schemes

The increase in pension contributions to the cost-coverage level has raised those contributions by approximately 50% since 2000. The Goudswaard Commission calculates (based on an estimate by the Netherlands Bureau for Economic Policy Analysis [CPB]) that failing to

³ Remaining life expectancy in 2020 will be approximately 1¾ years longer than the average life expectancy in 2000-2009. To mitigate the negative effects of this, the maximum increase upon each change date will be set at 1 year. This means that the age will be set at 66 in 2020, while the remaining ¾ of a year increase in life expectancy will be shifted to the next change date in 2025.

⁴ Actuarial neutrality is based on a computation. In connection with the pay-as-you-earn (PAYE) system, if retirement for state pension purposes (state pension age) begins at a later or earlier age, actuarial neutrality results in a lower offset percentage than it does for the occupational pensions in the second pillar, which are fully funded. The state pension, however, must take the interest effect into account.

⁵ Salaries comprise the employee's contract salary and incidental remuneration (i.e. changes in the gross salary attributable to such items as "extra" remuneration components or incremental pay rises).

⁶ Extra attention should be devoted to the purchasing-power effect in this regard. Over the longer term, coverage can be obtained through the additional revenues generated by linking the state pension age to life expectancy.

⁷ The effects on related legislation must also be examined. One particular point of attention is the provision in the International Labour Organization (ILO) Convention that specifically applies to seafarers.

change the pension policy could lead to comparable contribution increases. The parties agree that this must be avoided and cannot and will not become a reality.

The social partners have therefore made the following interdependent agreements:

- 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 following sections indicate how local entities can achieve this. Please note that this will not affect the possibility for parties to collective bargaining agreements to shift between pension and other employment benefits within their local overall employment benefits package.
- In a general sense, the social partners urge the government to refrain from imposing cost-increasing measures. The adjustment to the FTK must offer prospects for concluding new contracts without entailing increased costs (see Section 2.3). The consequences of governmental measures that nevertheless increase, or threaten to increase, pension costs, will be the subject of separate discussions amongst the social partners.
- Temporary shortfall contributions and temporary pre-pension contributions are not included in the aforementioned principal agreement on contribution stabilisation. The use of such contributions is a topic for local employment benefit discussions. The existing sector-specific schemes or agreements regarding how this surplus will be spent will be respected.

2.2 Dealing with the increase in life expectancy

The social partners also want to prevent increasing life expectancy from tacitly and stealthily raising target pensions for occupational pensions in the second pillar. 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.

The social partners believe that pension contracts must be adjusted with effect from 2011 to take into account the consequences of increasing life expectancy. This must be done in a fund-specific way that does not affect contribution amounts. The pension computation age and the state pension age must be harmonised.

- The following sections indicate how partners at the sector or company level (decentral social partners) can achieve this. Decentral social parties can choose from at least two methods for incorporating increasing life expectancies with effect from 2011. The Labour Foundation will establish a technical working group comprising experts from pensions industry umbrella associations and the Dutch Association of Insurers [*Verbond van Verzekeraars*] to test the methods for feasibility and consistency and to issue a report on their findings before 1 September 2010. The two methods, which lead to the same actuarial results, can be briefly described as follows:

- *Method based on conditional computation age*⁸

With effect from 1 January 2011, the pension computation age will be harmonised for pension accrual purposes with the announced raising of the state pension age. In other words, the pension computation age in 2011 will be equal to the state pension age that

⁸ This method is derived from the report of the Goudswaard Commission (p. 59) but is set out in specific terms in this Accord with regard to linking the pension computation age to the state pension age.

will apply in 2020 (66). In 2015, the pension computation age will be set at 67, which is the expected state pension age for 2025.

For the more distant future, the social partners endorse the same approach as that being taken with regard to the state pension, in other words making a generic adjustment to the pension computation age once every five years based on authorised data regarding life expectancy development. Additional adjustments to the pension computation age will not be made in the interim. This interim stability relating to the actuarial incorporation of longer life spans will naturally also apply to pension benefits that have already been accrued or are being received. This will have to be set forth in the regulations (i.e. the FTK). Changes to the pension computation age in the more distant future will affect not only new pension accruals but also the rights accrued with effect from 2011 – which is the effective date for incorporating increased life expectancy into pension contracts. This means that, from 2011, pension rights to be accrued will be conditioned on the increasing life expectancy.

○ *Method based on a fixed benefits period for all participants in a pension scheme*

The objective of this method also is preventing an increase in life expectancy from resulting in an automatic increase in cost-covering contributions. This will be achieved by choosing a fixed benefits period after reaching the computation age for all generations for pension accruals starting in 2011⁹. That fixed benefits period will not be adjusted for the increased life expectancy of future generations. By eliminating the link between the accrued rights and life expectancy, all generations will, in terms of costs, be treated equally for pension-accrual purposes. This method will enable the computation age to be determined and linked to the state pension age expected in the future the same as in the first method. The corresponding fixed benefits period will be determined based on the overall maximum contributions limit that was available in previous years.

- The contribution-neutral incorporation of increased life expectancy will be accomplished based on a fund-specific basis; in other words, it will be done on an industry-by-industry or company-by-company basis. In financial terms, there is no 1:1 ratio between working longer and living longer. A general estimate is that provision could be made for one additional year of life by working an additional six to eight months. In addition, the increase in remaining life expectancy for a particular industry or company might prove to be different from the forecast for the average national increase in life expectancy. This may mean that increasing the age to conform to the increase of the state pension age – assuming the contribution-neutral absorption of increased life expectancy – will be just enough to result in either surplus contributions or a shortfall requiring, for example, a decrease in the accrual percentage. The social partners agree that in the latter situation, any maximum contributions limit would, in the interests of contribution stabilisation, be kept within the fund and could be used for improving indexation quality or increasing the fund's ability to withstand negative developments, as well as for extra pension accrual that could result in a younger actual retirement age than the new pension computation age.
- Individual flexibility regarding the pension computation age. The social partners advocate for flexibility that would permit the actual retirement age to deviate from the pension computation age. Working past the pension computation age means that increased benefits

⁹ "Fixed" means that this does not involve an individual right but the average benefits period for all of the participants in a pension scheme.

can be accrued. Benefits would also be increased by having them paid out later. This would enable individuals to achieve higher pensions by postponing retirement. The opposite situation will arise for employees who wish to retire early. The social partners urge that decentral social parties make radical improvements in information and communication regarding pension benefits, as well as regarding the relationship between pension benefits, pension computation age and individual choices regarding retirement age.

In this Accord, the social partners are requesting decentral social parties to devote particular attention to the position of employees with long work histories. In the current average-pay schemes, young employees accrue very limited pension rights because their salary often barely exceeds the non-contributory threshold. The status of this category requires further examination to determine whether pension accrual can be improved at the beginning of their careers through cost-neutral revisions in the scheme and/or whether this group's position can be improved by exchanging a reduction in the non-contributory threshold for a reduction in the accrual percentage.

2.3 Progressing towards shockproof, transparent pension contracts for second-pillar occupational pensions

The target pension will be financed from pension contributions and from the return on investments. The target pension can never exceed the pension contributions actually paid or the returns actually achieved. This fact is often overlooked. The target pension is blown out of proportion and no longer reflects realistic estimates of the amount of the cost-covering contributions and/or returns on investment. The social partners hope that this Accord will bridge the gap between reality and ambition.

The current pension contract is insufficiently shockproof against developments on the financial markets (interest, returns, inflation). As a result of demographic changes, the contributions measure has become increasingly ineffective in terms of absorbing financial setbacks. The social partners see two primary alternatives for the current nominal contract:

- a “hybrid contract” with one layer of lower accrual with a large degree of nominal security and a second, fully performance-dependent layer (profit-sharing);
- a completely flexible (in real terms) contract.

The question in this regard is whether individual options (according to investment profile) can be incorporated so that the participants' bearing of investment risks can be coupled with more influence on how much risk is run. Both types of contract would still be bound to retain the fundamental characteristics of the Dutch second-pillar pension system (collectivity, solidarity and compulsory membership). The Appendix to this Accord sets out the primary characteristics of both contract types.

The social partners agree on the necessity for modernising the existing pension contract. The contract can only be made sustainable for the long term if it is transparent and can adjust to developments on the financial markets by virtue of having built-in financial shock absorbers. Performance-dependency is “for better or for worse”. Possible alternatives will have to be worked out at the local level in the coming years.

The financing of pension schemes must be proportional to the degree of certainty guaranteed by the pension contract. In its evaluation of the FTK the Cabinet asserted that the consequence of this is that the price of *current* pension contracts based on unconditional nominal

security will be higher than it is now. The social partners are aware of this and, therefore, are consciously choosing to modernise the pension contracts. This will require a further adjustment of the FTK, which means that new schemes must be subject to rules to ensure transparency about risks and communication. A revised FTK, along with the envisaged contract modernisation, should result in pension costs that will, on balance, remain the same (see Section 2.1).

Partly based on information of decentral social partners, the social partners will reach agreement at the national level with the government in January 2011 regarding the necessary adjustment of the FTK and the Pensions Act [*Pensioenwet*]. Based on that agreement, the legislative process can begin and decentral social parties can reach final agreements regarding the new pension contracts. By 2012, the pension contracts must have been adjusted and made shockproof in accordance with the guiding principles set out above. Customised, new parameter values should also accompany these fundamentally altered pension contracts. Obviously, the advice issued by the Don Commission in September 2009 could not have taken this fact into account, the logical consequence of which is that the social partners' position is that the current parameter values must remain in effect until 2012.

The social partners call on the government to enable the aforementioned changes to the pension contracts to be made by statutory and regulatory means. Pension legislation, the FTK and new parameters will have to be developed in tandem with the new contracts.

2.4 The Witteveen tax framework also requires adjustment

As follows from Sections 2.1 and 2.1, the Witteveen tax framework for supplementary pension schemes will also have to be adjusted with effect from 2011 so that the agreements and recommendations in this Accord regarding contribution stabilisation, the incorporation of increased life expectancy and the indexation of minimal state pension offsets to reflect salary developments (in conjunction with linking the state pension to salary) can be taken into account.

More generally, the social partners' position is that the government must provide enough tax leeway for occupational pensions to permit industry-specific flexibility.

2.5 Working towards a solid financial foundation for existing accrued rights

The social partners agree that pension rights that have already been accrued must be involved in some way in making pension contracts more shockproof. The two pension crises, as well as the increase in life expectancy seen over the last 10 years, have shown that there is good reason for doubting the financial solidity of existing pension rights (and pension schemes). Pension rights have been granted as a consequence of the increase in life expectancy without sufficient financing being arranged and/or with funding shifted towards the future¹⁰. The social partners do not believe it would be wise to shift this burden to the younger generation, since the adjustments to the pension contract must not undermine the solidarity that must be fostered between the group of participants that will fall within the scope of the new contract and those that fall within the old.

It is for this reason that the social partners take the opportunity of this Pension Accord to state that these problems must be expressly acknowledged and that balanced solutions must be

¹⁰ See Section 6.6 of the Goudswaard report.

sought. This needs to happen not just at central level by amending pension regulations, but the relevant parties at local level need to participate as well. One approach might be to adjust the indexation policy for categories for which insufficient financing was provided to take into account increased life expectancy of today's pensioners.

2.6 Improving asset management and good governance

The pension field at the level of decentral social partners has acknowledged the Frijns Commission's recommendations regarding the good governance of pension funds and greater expertise on the part of pension fund managers, including in the areas of asset management and effective risk management. The social partners are aware that pensions industry umbrella associations, in cooperation with the Dutch Central Bank [*De Nederlandsche Bank*], have taken the lead in properly implementing these recommendations. The social partners in the Labour Foundation endorse this approach, which should result in sufficient assistance being offered to pension fund managers as early as 2010.

As a supplement to this, the social partners would like to draw the attention of the pensions industry umbrella associations to two specific points.

First, the social partners' position is that it must no longer be a foregone conclusion that pension fund boards will automatically have to accept the candidates put forward by the nominating organisations. Pension fund boards are therefore encouraged to work with profiles when filling management board vacancies. This will also better enable the fund to implement the expertise plan with regard to the board as a whole. Candidates who do not meet the relevant profile going in cannot be appointed.

Working with profiles also offers the opportunity to improve diversity in pension fund boards. Currently, the social partners are working with pensions industry umbrella associations and a number of other public welfare organisations to prepare a voluntary agreement designed to improve diversity in all pension fund bodies. This will have to be a feature of the *Principles for pension fund governance* [*Principes voor goed pensioenfondsbestuur*].

The second area to which the social partners ask the pensions industry umbrella associations to devote attention is the necessity for management board members to have or be afforded a sufficient amount of time to properly perform their duties. This also means that they will have to be paid fitting remuneration that is proportional to the time required to perform those duties.

3. Improving the labour market position of older employees

Older employees' participation on the labour market has gradually increased over the past decade, partly as a consequence of changes in social security and early retirement regulations. The implementation of the changes to the state pension and supplementary pensions agreed in this Accord will further encourage this positive development. In addition, incentives are needed to make it more attractive for employers and employees to continue their mutual relationships.

The social partners will therefore develop an additional policy agenda to substantially improve the labour-market participation and mobility of older employees. This policy will discuss all of the relevant topics: age-conscious staff policies, recruitment and selection, employ-

ability, training, job flexibility (including aspects influencing their legal position and social security, as well as the “perverse incentives” in local schemes¹¹). Proposals will also be made regarding social security in relation to the implementation of labour market measures that are specifically geared to older employees. The social partners undertake to present this policy agenda in the autumn of 2010 and to periodically monitor its effects.

¹¹ Such aspects might be the provisions which are still included in early-retirement schemes that demand that employees stop working upon reaching a certain age (< 65 years) on pain of forfeiting their rights.

Appendix

This Appendix provides background information regarding Section 2.3 of the Pension Accord 2010.

Pension Act 2007

The current pension contract and Pensions Act make a distinction between *unconditional nominal* rights and *conditional* indexation. This distinction is important not only for the Pensions Act, but for the financial assessment framework (FTK) as well. Unconditional rights cannot be assailed; their high degree of security means that they must be protected by substantial financial buffers. But substantial financial buffers do not come cheap, and unconditional nominal rights are not worth much in times of high inflation.

This distinction between unconditional nominal rights and conditional indexation of these rights was explicitly formulated after the *dot.com* crisis and has been incorporated into the Pensions Act 2007, making it rather recent. Since the credit crisis (2008), other pension contracts have become the subject of discussion. These discussions have included pension contracts for which the total actual pension obligations – possibly within certain margins – could fluctuate along with the financial markets; in other words, the contract for *conditional and flexible realistic pension obligations*. Naturally there are alternatives that fall somewhere in between; there is a sliding scale between the conditional and unconditional elements of the pension commitments.

In this Accord, the social partners have agreed to further develop and detail the various pension contracts and the corresponding financial assessment frameworks and parameters. Not as a mere academic exercise, but as an urgent, policy-oriented analysis. The social partners want the new pension contract to enter into effect in 2012. Since changes are necessary, it is better to make them soon rather than later.

This Appendix first addresses why the current guarantees for the unconditional nominal obligations are insufficient. The alternative pension contracts are then briefly described. The social partners intend these descriptions to facilitate discussion about these alternatives at the local level. In January 2011, the threads of the contract and supervision discussions must be tied together and consistent choices must be made.

Before the analyses, a tautology is explained that might aid in structuring the discussion surrounding the new pension contracts.

This Appendix does not discuss either the trend towards longer lifespan (or the changes therein) or how pension funds have dealt with this area up to now and how they should deal with it in the future. These topics are discussed in Section 2.2.

Finally, a last preliminary remark. Nominal rights are often described as “extremely scanty”. But if we compare the nominal rights in 2010 with those in 2000, we can attribute the differences to three factors.

The *unconditional* nominal rights on date t regard:

- The sum of the annual notional accrual ($x\%$ per year; for example, 2% accrual) up to and including year t ;
- The indexation of this nominal accrual granted up to and including year t (the indexation decision may be conditional; once indexation has granted it forms a part of the unconditional notional accrual);
- the increase in life expectancy allowed for up to and including year t , as a result of which the number of years that benefits are paid ultimately exceeds the number of years that were taken into account when the contribution amount was established.

In other words: the nominal obligations on date t comprise the sum total of the nominal annual accruals, plus the indexation of these annual accruals, plus the increase in life expectancy that has been allocated up to that point. The last two elements are often forgotten, but they constitute a substantial portion of the unconditional notional obligations.

An incontrovertible truth

The Pension Accord stipulates that the target pension may never exceed the actual amount in contributions paid plus the actual returns achieved. This can be illustrated with a simple tautology:

$$\text{Target pension} = \text{contributions paid} + \text{returns achieved}$$

The target pension comprises four elements:

1. the desired amount of the annual pension;
2. the desired security of this pension;
3. the number of years the relevant recipient wishes to receive the pension;
4. the desired indexation of this pension.

The cost-covering pension contribution comprises at least two elements:

1. the purchase of new rights, given the desired amount of the pension and number of years the pension will be paid out;
2. the desired security of this pension, which is expressed in the buffer surcharge.

The returns achieved are often used for:

1. adding the obligations to the buffer;
2. financing the desired indexation.

The amount in contributions paid and returns achieved may vary from one scheme to another. Sometimes the desired indexation is financed through a surcharge on the actual contribution paid, sometimes the cost-covering contribution is kept low by taking into account the expected, future return on assets. Overall, however, the limits of the target pension are determined by the financing sources. A tautology, also known as an incontrovertible truth.

This tautology makes it easy to recognise the following connections:

- a higher target pension (for example, a pension that pays out over more years as a consequence of a longer life, a higher accrual or more security) must be financed by a higher contribution and/or higher return;

- if the total contribution is fixed and the returns are determined exogenously, a longer life must be compensated for by a lower accrual percentage and/or a lower indexation target and/or a lower degree of pension security;
- if the returns fluctuate and the contribution is fixed, the target pension will fluctuate (accrual, indexation, buffer);
- if the returns fluctuate and the target pension is maintained, the contributions must fluctuate by way of compensation (in the same ratio the pension assets bear to the pension base);
- and so forth.

Current guarantees for unconditional pension benefits

How are “unconditional” nominal pension benefits currently “guaranteed” (in accordance with the current Pensions Act and pension contracts)? Theoretically, there are four shock absorbers for setbacks:

- the contribution: disappointing returns must be able to be recouped through either temporarily increasing the contribution amount or through additional contributions being made by the sponsor company;
- the buffer: in addition to the nominal obligations, a buffer must be maintained as a safeguard; the amount of the buffer depends on a number of variables, but in situations involving “normal” risks and 97.5% security¹ the buffer is approximately 20%-25% (read: pension funds must strive for a coverage ratio of 120-125). Under normal circumstances, this buffer should be sufficient to absorb setbacks and, therefore, to safeguard the nominal obligations from the influence of shocks on the financial markets²;
- the indexation: limiting the indexation or not indexing at all. Indexing means increasing the pension obligations accrued up to a certain point (by linking them to increases in prices, salaries or both). Non-indexation prevents this increase, thereby preventing a deterioration in a pension fund’s coverage ratio. Put in positive terms, indexation is often partially financed with revenue from investments. In the case of non-indexation, part of this revenue from investments is not used to fund new pension obligations but is added to the buffer;
- the investments: by making less risky investments. Pension obligations can be “matched” by bond portfolio maturities and by the interest derivatives. In other words: the future cash flow from investment income can be geared to and determined by the future cash flow in pension expenditures. This type of investment policy is less risky and therefore reduces the effect that financial market shocks will have on the coverage ratio³.

¹ Technical: 97.5% security regards standard mean distributions, meaning that 97.5% of the setbacks in a single year can be absorbed by pension funds without falling below the bottom threshold of a coverage ratio of 105%. The year 2008 involved either abnormal “tail risks” (we estimate this in the 2.5% range) or the normal allocation was not applicable to financial phenomena.

² Pension funds can cover themselves against certain risks with the aid of financial products (foreign exchange hedges, interest derivatives). Because this limits the financial risks, the necessary buffers are also lowered (the difference can be some 5-10 percentage points).

³ There is another side to this type of investment policy; see below.

Necessity for contract amendment

Maintaining the current contract will lead to a number of significant problems:

- Employee populations are getting older (read: the average age of active pension members is increasing). The ratio between total earnings (on which the contributions are levied) and the pension assets is worsening: total earnings are becoming relatively smaller in relation to the pension capital. This can be simply illustrated on a macro scale: the annual contributions equal some 25 billion, while the pension capital equals some 650 billion. A one-off 10% increase in the pension contribution will improve the coverage ratio – once – by just 0.4%! This while a contribution increase always comes at a bad time (during economic setbacks when companies and industries are having to deal with many other setbacks). The conclusion is that increasing the contribution is no longer an effective measure for absorbing financial shocks. *“The contribution measure has lost its edge”*.
- The buffers seem insufficient (or at least they would be in the event of severe financial setbacks) and, moreover, do not take into account all the risks that pension funds run (such as liquidity risks, counterparty risks). One response might be: well then just increase the buffers (and in such case we would almost immediately be discussing an increase on the order of 5-10 percentage points⁴). The question is whether this would be an efficient solution: it would rather increase the costs of providing security for the existing notional obligations and, under the current circumstances, pensions would not be indexed for a long time in order to safeguard indexation in the future⁵. Once higher buffers had been achieved, there would be a benefit from the extra return.
- Non-indexation is compatible with the financial structure of the unconditional notional contract: the indexation is conditional. But non-indexation has invariably led to lengthy discussions and is seen as a loss in quality. On average, non-indexation would result in an increase in the coverage ratio of some 2 percentage points (see the CPB-MLT: 1¾ prices; 2½ contract salaries). Substantial setbacks would thus result in long-term non-indexation. And long-term non-indexation would be inconsistent with the current contract, or its participants’ perceptions of that contract. In short: a number of instances of non-indexation always results in discussion and is an insufficiently effective measure in the face of severe setbacks.
- Pension funds’ investment policy is in the spotlight. One camp is asserting that too much risk is run, which means that the nominal obligations cannot be “guaranteed” in the short term; the other is asserting that too little risk is run, which means that the realistic target will not be achieved in the future. This schism has meant that many pension funds have a “half and half” investment policy (half covering the interest but also participating in the high risk/high return market). Pension funds opt out of full matching because they would otherwise miss out on too many opportunities that are necessary for achieving the implicitly realistic pension target⁶.

The result of these developments will be that the focus in the current contract will increasingly lie on the nominal nature of the contract. This means that the contract will offer less and less protection against inflation, with the result being that participants will receive increasingly worse and lower pension benefits.

⁴ In other words: 32-65 billion.

⁵ Given the low coverage ratio and the possible consequences of new parameters.

⁶ The FTK puts it like this: firm nominal bottom thresholds stemming from the idea of unconditional nominal obligations.

New contract with built-in flexibility

Clearly, there is good reason for examining pension contracts' flexibility. That flexibility must be expressed in the pension contract, as well as in the corresponding assessment framework and parameters. The text of the Pension Accord refers to two primary alternatives, both of which must be worked out in more detail. The various elements that will be up for discussion in that context are the core provisions, effect, assessment framework, parameters, and amendments to the Pensions Act and other laws and regulations.

A: The hybrid contract: crux and flexible layer

The core of the hybrid contract is a lower, more secure nominal accrual, combined with higher flexible profit-sharing (indexation) and a pension contribution that is based on the current higher nominal accrual. The core results in a notional accrual that can reasonably be indemnified against pension reductions and the related problems in making allocations amongst participants. Another shock absorber, as it were, is being added: part of the pension obligations (for pension accrual) will be made flexible by making it conditional upon the returns achieved. Both the FTK and the role of the parameters must be tailored to this. Naturally, a forecast of the actual value of future pension obligations can be added to this.

This alternative permits various options to be added. The base layer can be created by opting for a low-risk mix of investments; as far as the profit-sharing layer is concerned, individuals can choose from various investment profiles/funds. This is an issue that will have to be worked out in more detail.

B: Provisional real obligations

In the second alternative, the obligations are in real terms defined and are completely flexible. No distinction is made between a lower, but stricter nominal accrual and conditional, possibly provisional profit distribution. These real obligations are, as a whole, variable and therefore respond more quickly to changes on the financial markets, also depending on whether or not financial buffers are in place. But a bottom threshold must be defined for the real coverage ratio. Dropping below this threshold entails the direct reduction of the participants' actual rights to avoid falling below the minimum coverage ratio. Otherwise there would be too much pressure on the solidarity between pensioners and younger employees who are still working. Parallel to this, the real FTK, of which only an outline is available at the moment, will have to be developed and worked out in more detail. This is also true for the amount and role of the parameters. This contract will also require intensive communication with the participants, since the pension obligations will fluctuate in tandem with the financial markets, and to a much higher degree than is currently the case.

Procedure

The Accord stipulates that the social partners will consult one another and the legislature in the second half of 2010 regarding:

- the parameters: their amounts and roles in the various contracts;
- the various types of contract;
- the financial assessment framework for the hybrid contract;
- the financial assessment framework for the realistic, variable contract.

This consultation must result in conclusions for the supervision framework and related issues in January 2011, so that decentral social parties in the pension field can make informed choices in the course of 2011 from the flexible contracts and related financial assessment

frameworks, both of which will be predicated on sustainability in terms of affordability, solidarity and their ability to withstand financial setbacks.