Your pension is uncertain

Open letter

February 2011

NBA

Nederlandse
Beroepsorganisatie
van Accountants

NBA

The Royal NIVRA and NOvAA are set to merge, resulting in the establishment of a new organization, the NBA (Nederlandse Beroepsorganisatie van Accountants - The Netherlands Institute of Chartered Accountants).

The NBA's membership comprises a broad, varied occupational group of over 20,000 professionals working in public accountancy practice, at government agencies, as internal auditors or in organizational management. Integrity, objectivity, professional competence and due care, confidentiality and professional behaviour are the fundamental principles for every accountant. The NBA assists accountants fulfil their crucial role in society, both today and in the future.

Postbus 7984
1008 AD Amsterdam
Antonio Vivaldistraat 2-8
1083 HP Amsterdam
T 020 301 03 01
nba@nba.nl
www.nba.nl

To pension funds, their members and
other interested parties

Date	Subject	Reference	Enclosure(s)	Direct-dialling number
February 2, 2011	Pensions		Five signals	+31(0)20-3010318

Nederlandse Beroepsorganisatie van Accountants

NBA

Dear fund managers, members and interested parties,

The credit crisis has left deep scars. The Dutch pension system, and the pension funds in particular, are being seriously put to the test. There is uncertainty as regards their ability to honour current and future pension commitments, trends in both short and long-term interest rates, rising life expectancy, future investment results and new government and regulatory requirements. Questions are being raised in the political arena regarding the sustainability of the pension system in its current form. At issue here are the current and future pensions of millions of Dutch citizens, who want to know whether their pension entitlements will be protected against inflation (inflation-proof pension payments) and whether their entitlements will be fixed to specific cash amounts (fixed pension payments). They even wonder whether pension payments may actually fall.

These problems and their possible solutions constitute a debate of major social importance. The *Nederlandse Beroepsorganisatie van Accountants* (The Netherlands Institute of Chartered Accountants; NBA) wishes to emphasize the public role that accountants play by contributing to this debate. Indeed, the technical and financial aspects of pensions mean that many accountants are very familiar with these issues. Accountants do of course have a duty of confidentiality. Nevertheless, providing it is anonymised, their knowledge can be shared with each other and with our Identification Board. We subsequently requested a response from pension experts, including employees of the Ministry of Social Affairs and Employment, the Dutch Central Bank and the Pension Federation.

These exchanges resulted in the formulation of five signals, which are detailed in the enclosure and to which we would like to draw your attention:

1. Don’t change the rules during the game: cutbacks may prove unavoidable
2. Assess the position of pension funds: insight into uncertainties
3. Pension fund or investment institution: a shifting risk profile
4. Pension funds and insurers: apples and oranges
5. Don’t make it too complicated: test the feasibility

Yours faithfully,

drs. Ruud Dekkers RA
Chairman Royal NIVRA

prof.dr.mr. Frans van der Wel RA
Chairman Identification Board

NIVRA en NOvAA gebruiken de merknaam NBA (Nederlandse Beroepsorganisatie van Accountants).
De wettelijke fusie van NIVRA en NOvAA tot NBA moet nog plaatsvinden.

Five signals

1. DON'T CHANGE THE RULES DURING THE GAME: CUTBACKS MAY PROVE UNAVOIDABLE

The Pensions Act and the Financial Assessment Framework (FAF) determine when pension funds are to take additional measures to bring their financial buffers up to the required levels. These rules of the game were developed several years ago on the basis of divergent economic scenarios to be applied in both good and bad times. But now that bad times are upon us, we see a threat that the rules might be amended instead of applied. The use of measures to restore the financial buffers is being called into question. Opportunism is in the air. It is argued that we are dealing with an uncommonly severe economic scenario that requires the rules of the game to be changed.

The rules prescribe buffers for bad times. A worsening financial position of pension funds due to interest rate developments, life expectancy and the financial markets have forced funds to draw upon these buffers. The buffers must now be restored to the required levels so as to withstand future setbacks. That is what the rules of the game prescribe. In terms of business economics, if pension coverage shortfall cannot be compensated through (a combination of) premium increases and higher investment yields, the buffers will not recover sufficiently. In such a situation, cutbacks on pension entitlements and benefits will be unavoidable. In a situation where the coverage ratio is less than 100%, a pension fund board which concludes that cutbacks are not necessary will have to justify this decision to members who have not yet retired. The board will also have to explain what this means for the index-linking of members' pension entitlements. After all, with a coverage ratio under 100%, the pension fund board is paying out more money to current retirees than it has proportionally available for them.

2. ASSESS THE POSITION OF PENSION FUNDS: INSIGHT INTO UNCERTAINTIES

The effects of recovery measures are calculated in detail, with today's coverage ratio serving as an important point of departure. But pension funds base the valuation of their commitments and that of a portion of their investments on estimates and assumptions regarding future developments. The horizon of these estimates and assumptions can extend as far as 60 years. It is important to understand that, for instance, the estimates for future survival probability are based on statistic models. What is inherent in these estimates is their uncertainty. The one thing we can be certain about is that reality will diverge from the estimate.

Taking decisions based on the coverage ratio, for example, without considering the inherent uncertainty, is deemed undesirable. We believe that the uncertainties inherent in estimates should be qualitatively and quantitatively analysed and communicated. Pension funds should communicate sensitivity analyses in the form of a probability distribution of pension results. Such an explanation could be worded as 'assuming the current coverage ratio, there is an X% probability that there will be coverage shortfall in the next 20 years and a Y% probability of an inflation-proof pension benefit during this period'. This reduces the relevance of the coverage ratio as a point estimate and, consequently, the discussion regarding coverage ratios that can sometimes involve tenths of percentages. With probability distribution, policy would be easier to explain and members would be more conscious of the uncertainties, even if their pension fund is healthy.

3. PENSION FUND OR INVESTMENT INSTITUTION: A SHIFTING RISK PROFILE

The objective of pension funds has always been to pay their members adequate levels of benefits at a reasonable cost. Pension funds meet this objective by collecting premiums which are then invested in, for example, bonds and shares. Market trends have been declining steadily over the past few decades and the expected returns on bond investments have come under pressure. In order to continue to meet their members' expectations, the funds went in search of higher-yielding investments with related higher risk profiles. During the financial crisis, however, unexpected risks emerged whose origins lay in illiquid markets or in complex investment products, such as derivates.

However, what many members mainly want is a secure pension sum since this will constitute an important part of their income in supplement to the Dutch state pension (AOW). This calls for a moderate risk profile. As things now stand, a lower risk profile means a lower probability of indexations being awarded in the future and, therefore, a lower likelihood that members' pensions will be inflation proof. It is in fact a trade-off between expectation and certainty based on associated return and risk. We believe that reporting by pension funds to members should contain more relevant information on the firmness of promised pension benefits, raised expectations and the associated risks for members. The effects of any board decisions to raise or lower the risk profile of the pension fund must be communicated to allow the member to determine what the consequences will be for his or her personal situation.

4. PENSION FUNDS AND INSURERS: APPLES AND ORANGES

We are currently witnessing a market development involving the termination of pension funds. The pension schemes operated by these funds, including any assets and liabilities, are transferred to insurance companies. This development can create the impression among members that their current pension schemes (and any related expectations) will continue unchanged, but with increased certainty for members. However, schemes operated by insurers are normally different in design: with insured pension schemes, the emphasis lies on guaranteeing the accumulated nominal pension entitlements. Pension funds, on the other hand, operate with a double objective: achieving the nominal entitlements **and** indexation.

It is important that members of a pension scheme are given a clear insight into benefit promises (nominal or inflation proof), expectations (probability of payment and indexation) and risks (profile of the investments and other important risks). Having this insight is not only important for the member if his or her pension fund is taken over by an insurance company, it is relevant for the entire period he or she is a member of a pension scheme. The existing Uniform Pension Overview (UPO) does not provide for this information requirement. We argue for members to be provided with more relevant and uniform information, in a format used by both the pension funds and the insurance companies.

5. DON'T MAKE IT TOO COMPLICATED: TEST THE FEASIBILITY

Following the Social Accord of 4 June 2010, the government, employers' organisations and employee representative organisations are currently examining a number of solutions to the pension dilemma. These discussions will result in the amendment to the so-called model pension contract: the basis for many pension contracts in need of modernisation. One of the ideas being proposed is to categorise the pension commitments the funds have vis-à-vis pension beneficiaries into 'firm' promises on the one hand and 'soft' promises on the other. While the pension beneficiary will be able to count on the 'hard' promises, such guarantees will explicitly not apply to the 'soft' variety. For the majority of pension funds, the annual indexation of pensions currently constitutes such a soft promise. It is being negotiated whether this approach should not also apply to some of the entitlements to the nominal pension. This would increase the uncertainty to the member. Regardless of whether they were reinforced by transitional provisions, the new pension contracts would probably become even more complicated. Administrative costs will rise and the risk increases for the pension schemes administration to run 'out of control'. We suggest keeping new provisions simple and to subject any intended changes to the pension contract to a feasibility test. This test could focus on the principle of 'managed and honest business operations (including risk management)' as referred to in the Pensions Act.

Response from the Pension Federation

The Pension Federation, the umbrella organisation of the Industry pension funds, the Corporate pension funds and the Occupational pension funds, is pleased to take this opportunity to respond to NBA's open letter containing the five signals that are certainly worthy of consideration. The fact that NBA, as a party with no primary interest, also feels the need to publically express its insights and views regarding the supplementary pensions proves all the more that the subject of pensions is socially relevant.

In recent years we have learned that the existing pension contracts are no longer sustainable. The new pension contract – the subject of intensive ongoing negotiations between the social partners – must solve two structural problems: rising life expectancy and the growing dependency on investment returns coupled with the increasing uncertainty that involves. Pensions must become more future proof and that will require, among other things, an amendment to the Pensions Act and the existing Financial Assessment Framework.

For the Pension Federation it is of eminent importance that the new pension contract is implementable and financially sustainable. However, it is also important that the new schemes can be explained to members. The new pension contract must therefore not be overly complicated. That is a considerable challenge, and it is made even more so by the fact that designing new contracts which may or may not include previously accumulated rights is a technically complicated subject, and one that will not be easy to communicate. On that note we would like point out that further expanding the provision of uniform information to members, as NBA suggests, will not automatically lead to more knowledge, insight and understanding. As it is now, many members never read the existing Uniform Pension Overview as they consider it too extensive.

Pension contracts have a very long time span, sometimes up to 60 years. With periods of that length, we must realise that 100% guarantees at acceptable costs are not possible. Precisely because there are no full guarantees, Dutch pension funds have been able to offer members adequate pensions in return for reasonable premiums and at low administrative costs for decades. The challenge for the social partners, government, regulator and, of course, the sector itself is to continue ensuring this in the future.

Publication details

SHARING KNOWLEDGE IN THE PENSION SECTOR

In this letter, NBA presents five signals (and recommendations) to all interested parties in the pension sector. The pension sector is the third subject that NBA's Identification Board selected for the Sharing Knowledge policy programme. A working group of external accountants who audit pension funds have collected and discussed anonymised findings and opinions. In doing so, they involved other accountants and consulted stakeholders. The Identification Board placed the signals into their social context. The Pension Federation was willing to respond to the open letter in writing. The Sharing Knowledge programme team was responsible for coordination. The board of management of the NBA greatly appreciates their contributions.

Identification Board
prof.dr.mr. F. van der Wel RA (chairman)
prof.dr. M.N. Hoogendoorn RA
R.J. van de Kraats RA
L.A.M. van den Nieuwenhuijzen RA
drs. M. A. Scheltema

Pensions Open Letter Working group
drs. F.J.J. Glorie RA
drs. M. van Luijk RA
drs. J. Niewold RA
N.M. Pul RA
drs. H.C. van der Rijst RA
W. Teeuwissen RA

Sharing Knowledge Programme team
drs. R.B.M. Mul MPA (chairman)
M.J.P. Admiraal RA
drs. I.H. Kramer RC
drs. R.H.M. Schouten RA RE RO

FURTHER DETAILS

An open letter is one of the types of publication issued as part of the Sharing Knowledge policy programme. NBA previously published two public management letters on the subjects of Insurances (June 2010) and Healthcare (November 2010). All publications are public and are intended for a broad readership. For more information on the content of this open letter, please contact R.H.M. Schouten on tel. +31(0)20-3010318 or via email at r.schoutenl@nba.nl. More information on the Sharing Knowledge programme is available on NBA website: www.nba.nl.

Nederlandse
Beroepsorganisatie
van Accountants

NBA

Antonio Vivaldistraat 2-8
1083 HP Amsterdam
Postbus 7984
1008 AD Amsterdam
T 020-3010301
F 020-3020302
E nba@nba.nl
I www.nba.nl