

# pension

## BACKGROUND

FOR POLICY ADVISORS, MANAGERS, POLITICIANS AND ACADEMICS

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## Introduction



I am pleased to present this English edition of Pensioenachtergrond, therefore relabelled Pensionbackground. This edition is a special issue of our regular magazine on the occasion of the opening of our Brussels Office. This edition has been presented at our Brussels seminar 'Focus on Pensions' celebrating APG's recent establishment in the centre of the European district, at the Rond Point Schuman.

APG is of the opinion that it is of importance to be represented in Brussels. Although from a subsidiarity point of view pensions and pensions arrangements remain predominantly a national policy issue there are important aspects linked to EU policies to

be taken into account, such as:

- how to improve the functioning of the internal market
- which reforms are necessary in order to guarantee adequate pensions within a stringent budgetary framework
- what to do to enhance the stability of the financial system.

Those policy issues, clearly mentioned in the Commission's Green Paper towards adequate, sustainable and safe European pension systems, trigger EU regulation. It is important that the special position of collective pensions is well understood by decision makers in Europe. Therefore APG wants to be part of the decision making processes by coming forward with practical solutions and advice to EU policymakers. As recognized in the Green Paper a more sustainable footing is more and more based on multi-tiered systems. Our experience as Dutch pension service provider can be of use to us all in order to achieve our common goals.

In this Pensionbackground you will find insights in and actualities about pension topics from an European point of view. First Angelien Kemna, Chief Investment Officer of APG, comments on her strategy of 'Controlled simplicity' and the role of European regulation in her day-to-day work.

Guy Verhofstadt foresees that EU citizens and pensioners will be kindly asked to pay the bill if pension funds are not excluded from mandatory central clearing for over-the-counter (OTC) derivatives. The European Commission is currently in the midst of the decision making process around this topic. The second article is from his hand.

In the third article Wilfried Mulder and Hans van Meerten discuss the new IORP regulation and the challenges and chances this will offer for Dutch pension sector.

Finally, Michiel Evers, Jurre de Haan en Barthold Kuipers write about the situation of pensions in Europe after the financial crisis. Their analysis shows that there is a good reason to be proud of our Dutch pension system.

Dick Sluimers  
Chief Executive Officer



# Controlled simplicity

Angeliem Kemna  
*Chief Investment Officer APG*

The early spring of 2011 is proving to be a challenging one for the pension sector. Negotiations about a new pension contract are dragging on, the investment policies of pension funds are the subject of critical debate in parliament, and trust in the sector, eroded by newspaper headlines and television documentary programs such as Zembra, has almost entirely disappeared.

Amid all the consternation, however, day-to-day work goes on: pensions must be paid and pension capital invested. Angeliem Kemna of pension investor APG therefore prefers to steer clear of the commotion. 'Our job is to properly look after the participants' pension capital, and we are focusing on that.'

As chief investment officer of APG, Kemna is responsible for approximately 277 billion euros in pension assets of over 4.5 million Dutch citizens. Work in this regard must above all be performed in an orderly manner that is in keeping with the ultimate objective of the pension funds that are APG's clients, namely meeting pension commitments. 'I am very much in favor of returning pension investments to their original purpose.'

### Simplification

Since succeeding Roderick Munsters at the helm over a year ago, Kemna has therefore launched the 'controlled simplicity' project and, with a view to the future, is guiding APG's pension assets management back to its essence. 'Such a 'back to basics' approach means taking a step back and asking: why do I have those investments again? What is their purpose? Pension investment is not about chasing mandates. It's about looking at which risk factors can contribute to a balanced return in relation to the liabilities.'

In Kemna's view, excessively developed investment products

often do not serve that aim. 'We've gone through a period of extreme financial innovation. It's time to leave that behind and, before doing anything else, identify the true sources of performance, because a lot of those innovative instruments are complex and add very little.'

'Controlled simplicity' means refraining from investing in unnecessary innovations and, rather than making the alpha – the expensive bits of additional return – the main priority, ensuring first and foremost that the basic market exposure – in other words, the beta – is sound. It also means, however, refraining from indiscriminately adopting all kinds of commercial benchmarks. As Kemna explains, 'We live in an investment environment that is over-engineered and in which we all use the same benchmarks. It has now been shown that this causes certain inefficiencies in the market. There are day traders who do nothing else other than take advantage of this situation. Moreover, such benchmarks result in the inclusion of things in a portfolio that are of no use whatsoever to that portfolio.'

Kemna cites government bonds as an example in this regard. 'For a long time, they were seen as safe investments and pension funds invested primarily in the eurozone. To achieve spread across government securities of different countries, however, an extensive range of benchmarks were at one point introduced in which the PIGS countries – countries at the periphery of the eurozone – were also

strongly represented. When things went wrong, pension investors realized that they had reached a situation that had never been intended. The intention had been to invest in government securities as a safe way of matching the duration of the liabilities. Instead of that, funds had acquired a government bond risk that they had not by any means wanted.'

There may very well be good reasons to invest in government bond risk. 'It is often driven by macroeconomic factors and can be an interesting risk factor that responds very differently from corporate bonds, but it is then better to explicitly state that risk and invest in it separately, independently of the government securities portfolio intended to match the liabilities,' Kemna explains. 'If you opt for that exposure, you then look for a standard of measurement. This can be a benchmark that is available

marks. For example, there are asset managers that offer a corporate bond fund but achieve additional returns by circumventing the benchmark and investing in debts of emerging markets. This ensures favorable performance but, without it being noticed, also mixes corporate bond risk with the national debt risk of emerging markets. We do not wish to mix risk factors that interfere with each other on block level. Separating them makes it possible to invest in a purer way.'

#### Back to basics

Efforts to bring asset management back to basics initially focused on fixed income securities. The intention, however, is to extend this way of thinking into other categories, such as shares and real estate.

'The beta exposure is the most important thing with

**'We want to aim at engaged, long-term share ownership in which we invest in larger interests and exercise actual influence on the management of the companies involved'**

in the market, but it does not necessarily have to be. The choice for a benchmark must in any case not be an automatism.'

Different risk factors are sometimes unintentionally jumbled together when commercial benchmarks are used. APG has far-reaching plans in place to separate those risk factors with respect to fixed income securities. 'Doing so makes it possible to avoid a range of undesirable situations, including the games people play with bench-

respect to shares. Because of our size, we wish to invest a large part of the portfolio in the index. We wish to do so, however, in an intelligent way. Instead of simply following the benchmark, which everyone knows will entail a haircut, we wish to focus on a number of factors like low volatility, momentum, value, and dividend, which makes it possible to achieve the required index exposure in a better way,' Kemna explains.

'At the same time, we want to aim at engaged, long-term

share ownership in which we invest in larger interests and exercise actual influence on the management of the companies involved,' she says. 'On the one hand, therefore, intelligent index investment can ensure the necessary spread and market exposure in an efficient and inexpensive way, while, on the other, there are a number of shares on which our fundamental analysts focus and in which we are really concentrated.'

APG is currently developing proposals to extend the course taken with respect to fixed income securities into shares and real estate. 'We are doing this in phases, in close consultation with our clients, and it's a reason for controlled simplicity, with an emphasis on controlled. All of us really went too far in that whole traditional, mandate-based way of thinking, and we are now gradually freeing ourselves a bit from it together with our clients,' Kemna explains.

'By doing so we are distinguishing ourselves from commercial asset managers. I think it's necessary to be that bold, because our objective is also different; our objective is first and foremost to take proper care of the money that a very large number of people have entrusted to us.'

### A dangerous false sense of security

As a pension investor, APG's benchmark first and foremost comprises the long-term pension liabilities. APG is therefore a quintessential long-term investor. However, it is becoming increasingly difficult to fulfill this role, something that Kemna is deeply concerned about.

'Partly in reaction to the crisis, rules are being imposed on institutional investors that are forcing them to respond to short-term developments. If this situation persists, there will no longer be any large long-term investors anywhere in the world. This will also mean the end of the stabilizing, contra-cyclical effect that they have on the markets. This is currently one of the greatest risks throughout the world.'

The problem is compounded when different sets of regulations reinforce each other's impact. An example in this regard concerns currency risk. From a long-term

perspective, there is not much reason to hedge that risk, since exchange rate movements can cancel each other out in the course of time. 'In the short term, however, money can be lost due to currency differences without any gains being made, and a pension fund is therefore relatively heavily punished pursuant to the financial assessment framework for taking currency risks. For over-the-counter derivatives, however, more stringent regulations are being drafted that will make it considerably more expensive to hedge this risk by means of currency derivatives. Moreover, the Basel III regulatory standards oblige merchant banks to maintain higher buffers, and this is directly passed on to pension investors that conclude derivatives contracts with these banks and brokers.'

One the one hand, therefore, parties are being forced to hedge that risk, while, on the other, we are heading toward a situation in which it will be prohibitively expensive to do so. 'Pension investors like us would then have to make very difficult choices. It could very well be that we would have to invest less on a worldwide basis as a result. This means that we would no longer be able to optimally spread pension investments across assets available throughout the world, and it would therefore be necessary for us to run higher rather than lower risks with the pension capital,' Kemna warns. 'In my view, not everyone is aware that we are on the eve of those kinds of decisions.'

From her time at ING in the early 2000s, during which she had to implement regulations pursuant to the Sarbanes-Oxley Act passed in the wake of accounting scandals at companies like Enron, Kemna has first-hand experience of the sense and nonsense of restrictive regulations. 'Such regulations make it possible to properly manage operational risks, but they did not prevent the financial crisis. In other words, if a medicine is not working, is doubling the dose necessarily the way forward? I don't think so. One must first ask whether the medicine is working, and whether or not the cure is worse than the disease.'

The opposite of what was actually wanted will be achieved if long-term large investors are forced to de-risk in a pro-cyclical way. According to Kemna, there are more

# ‘A financial regulator must be strict when it comes to the risks and governance issues associated with outsourcing relationships, asset management, and pension administration.’

than enough poignant examples. ‘Consider the Greek bond crisis. Under the pressure of regulations, investors had to reduce their risk and Greek debt securities were therefore dumped, which exacerbated the debt crisis. Last year’s unnaturally low interest rates are another example. This phenomenon was also institutionally driven and based on regulations.’

Although such regulations reduce risks in the short term, a very different risk is introduced through the back door. This is because, by their nature, long-term investors constitute a counterweight to investors that operate with a shorter horizon. ‘If everyone is forced to act on a short-term basis, all investors will move in the same direction, which will amplify major displacements in the market. The blows we are witnessing in the markets are in part caused by the fact that people are not allowed to simply sit out adverse periods.’

Kemna hopes that that cycle will be broken, otherwise ‘we will lull ourselves into a dangerous false sense of security in the short term that will prove extremely costly in the long term.’

## Thumbs up for regulators

The above does not mean that Kemna does not favor the regulation of financial markets. On the contrary, ‘A financial

regulator must be strict when it comes to the risks and governance issues associated with outsourcing relationships, asset management, and pension administration. Strict regulation in these areas assures our participants that we are properly looking after their money and that nothing strange can happen.’

Kemna also favors a hawk-eyed regulator with respect to innovative products like longevity swaps, because ‘this is the product of the moment. Everyone has to deal with longevity risk and therefore wishes to purchase longevity protection. It would be extremely exasperating if this leads to the same scavenging that we saw with respect to credit default swaps. Very quickly, it would become impossible to tell who is long or short in that risk and who the counterparties are. Furthermore, would the valuation basis be clearly understood and would a buyer remain aware of what exactly he is buying? The first of these products are currently being developed and offered, and should therefore be carefully scrutinized by regulators before any problem arises.’

There are areas in which Kemna would welcome more targeted monitoring by financial regulators and more refined regulations. Examples in this regard are the Basel III regime for banks, Solvency II for insurers, and the solvency framework for pension funds. ‘Banks, insurers,

and pension funds are fundamentally different institutions, and it would therefore only be right to set up a different regulatory framework for each type of institution. In this sense, it is also certainly important for pension funds to have their own framework and not be subject to Solvency II,' Kemna says.

'If three different regimes are developed, however, it is important for them to be seamlessly linked to each other, because people always seek loopholes. Gaps between different regimes provide opportunities for arbitration, and people take advantage of those opportunities. It is already happening with respect to Basel III and Solvency II.'

According to Kemna, the regulation exercised must respect the essential differences between different kinds of market players 'but, when doing so, must assume the worst about all players and keep a close eye on how people seek to use opportunities for arbitration. That would certainly be highly desirable.'

Within the pension fund sector itself, it is also important for the regulatory regime to be closely linked to the system of regulations as a whole. 'If a very different pension contract is introduced, the regulatory framework will have to be adjusted to it quickly,' says Kemna.

'We must think carefully about the consequences that a new contract will have for the asset management of pension funds, all the more so because, with pension assets totaling approximately 800 billion euros, we are not operating in a vacuum. If the entire pension sector makes a U-turn, it will have a major impact on the markets,' warns Kemna. 'Countless hedge funds and investment banks are monitoring what we are doing here in the Netherlands. For hedge funds, there is nothing nicer than a change in regulations, because there will be opportunities aplenty for such funds if an entire group of pension investors is forced to adjust its asset management in a certain way. Such consequences must be carefully studied in advance.'

Kemna is positive about the way in which the two sides of industry are dealing with the effects of the new pension

contract. 'They were given and took the time to comprehensively discuss the matter with each other, and the problems that they are trying to solve are considerable. For example, a truly insufficient amount has been saved for the higher life expectancy that is already a factor today. Greater longevity is simply very expensive.'

Whatever the outcome of the negotiations, Kemna is confident that the system will be able to continue providing people a good pension, even if pension payments must be somewhat reduced to compensate for higher life expectancy and in spite of the two crises that we have been through since 2000. 'Crises come and go, but the pension remains,' she says. 'For almost twenty years, we have been achieving an average return of around seven percent for our clients, and that's not bad at all.'

That we have to accept a reduction in pension payments because we are living longer is only logical in Kemna's view. 'Solidarity is perhaps an old-fashioned word, but I am very much in favor of ensuring that the youth of today will also be able to benefit from the system in the future. I have seen in America what can happen when people are individually responsible for their pensions. We are then talking about reductions and losses that are of far greater magnitude than those that apply in the Netherlands, and then I think: we have a good system here, and we should be willing to do what is necessary to maintain it.'

*This interview was published in IPN number 19, April / May 2011.*



Mariska van der Westen  
IPN

EU citizens and pensioners are kindly asked to pay the bill



## The European Commission's OTC derivatives proposal leads to higher contributions for ordinary EU citizens, increased risk and lower pay-outs for pensioners. The European Union is currently in the midst of the decision making process how over-the-counter (OTC) derivatives are cleared.

Under these rules, OTC derivatives will have to be cleared through a central counterparty (CCP), and assets will have to be posted as collateral (in the form of upfront margin and daily variation margin). Derivatives that are not cleared via a CCP will be subject to added capital requirements although the details of this are not yet known.

One important topic is whether pension funds should be excluded from mandatory central clearing. To be clear from the outset, if no full exemption will be granted to pension funds, it may just be a matter of time before EU citizens, saving for their retirement, or pensioners will have to pay the costs for this battle. If pension funds are forced into central clearing, this scenario will pose a serious problem to pension savers or retirees. High fees, dead money to be set aside in the form of collateral will have to be compensated by higher contributions or lower pay-outs. All this without clear advantages.

After months of ignoring the problem, now it seems that policymakers in Brussels, in the Council and in the European Parliament, recognise that pension funds do have a justified case. A temporary exclusion is now being discussed. The currently debated temporary exemption from the clearing requirement seems sympathetic, but it does not solve the problems the pension funds raise. Such an exemption would only postpone the discussion to a later stage, avoiding a real solution for the acknowledged problems. It is not clear how the impact of the new regulation will be mitigated in three years time. Why would it be

logical to exclude pension funds now and put them under the derivatives regulation after a period of three years?

European pension funds are conservative long term investors using liability driven strategies. They are heavily regulated. Their strategy focuses on the pension-fund assets in the context of the promises made to employees and pensioners. As such, European pension funds hedge exposure to changes in interest rates, currency rates and inflation by using OTC derivatives. OTC derivatives shall only be possible insofar as they contribute to reduction of investment risks as stipulated by the European IORP Directive; pension funds are not allowed to speculate with OTC derivatives.

Forcing pension funds into central clearing implies higher risks and higher costs and hardly any advantages. If pension funds are forced to clear through a CCP, they will be required to post collateral to a CCP. Contrary to the current situation where less creditworthy market participants have to post upfront margin (initial margin), initial margin will also be required from pension funds. Due to their size and their one sided exposure, pension funds will have to post huge amounts of initial margin. CCPs will also require variation margin to be posted in cash, where pension funds now also post this in the form of government bonds. This will create liquidity risk and have a significant cost impact.

Forcing pension funds to clear trades seems also to be a

# ‘Forcing pension funds into central clearing implies higher risks and higher costs and hardly any advantages.’

redundant exercise from a risk mitigating perspective. By making a CCP mandatory, the extremely high creditworthiness of pension funds is absorbed by less conservative, more risk seeking and less solvent participants in the clearing system. Pension funds do not want to be obliged to bear the risks of such parties, or even subsidize their activities. As hedging end user, pension funds did not cause the financial crises. From a pension fund’s risk perspective, mandatory participation in a central clearing system does not add value above the currently functioning bilateral derivatives arrangements, which are properly netted and collateralised and accompanied by optimal risk management tools.

Pension funds believe that transparency and effective risk management are key elements to reduce systemic risk in the OTC derivatives markets. As long as they do not have to publicly disclose their OTC position instantly and in a detailed way, subjecting them to transparency requirements and strict risk management requirements for bilateral OTC trades should suffice. Details on the transparency regime could be agreed upon in close co-operation with the new European Supervisory Authorities.

Not all European politicians are very sensitive for such arguments. Despite the lack of convincing, valid arguments they want to push pension funds onto CCPs, saying that this will make the financial system more stable. It will not, it only puts EU citizens’ retirements savings and pay-outs at risk.



Guy Verhofstadt  
*Member of the European  
Parliament  
Chair of Alde group*





The Premium Pension  
Institution:  
a new Dutch IORP

# It is very likely that The Netherlands will introduce a new pension vehicle in the near future: the Premium Pension Institution (PPI). In July 2010 the Second Chamber (the lower house) of the Dutch parliament adopted a law that will introduce the PPI in Dutch legislation.<sup>1</sup>

By means of the PPI the Netherlands will be able to position itself as an excellent location for the establishment of cross-border operating pension vehicles (Institutions for Occupational Retirement Provisions; IORPs). Several factors contribute to this:

- 1) the PPI is a relative simple and transparent vehicle;
- 2) the PPI has a competitive tax regime; and
- 3) the PPI benefits from the mature Dutch pension industry as well as a transparent and solid set of Dutch supervisory rules.

In this article we will discuss some of these features in more detail. First of all we will describe some international trends with regard to the pooling of pensions, and the position of the Netherlands.

## International trends and the position of the Netherlands

With the introduction in 2003 of the EU-directive on the activities and the supervision of institutions for occupational retirement provision (hereafter to be referred as the IORP-directive, or IORP)<sup>2</sup> a first step towards an internal European pension market was made. An important element of the IORP-directive was the introduction of the possibility for pension institutions to operate cross-border.

Nowadays, we see two trends. First of all multinational companies are increasingly investigating the possibilities of establishing (group) pension vehicles which can operate

pension schemes on a cross border basis (also known as 'pension pooling'). This is a new trend, since until now the attention of multinational companies seemed to be focussed primarily on asset pooling and solutions for expatriates.

A recent feasibility study for creating an EU pension fund for researchers confirms this trend.<sup>3</sup> In this study it can be read that it is expected that the number (of single-employer) cross-border IORPs will increase significantly over the next 2-3 years once the practice becomes more established, and more multinationals realise that cross-border IORPs have become a practical reality at last.

Secondly, in previous years several EU-Member States (e.g. Belgium, Luxembourg, Ireland) have used the implementation of the IORP-directive, by means of the introduction of new pension vehicles in their legislation, to position themselves as an attractive country of establishment for internationally operating pension institutions.<sup>4</sup>

Traditional pension fund in the Netherlands have to fulfil several conditions which are specifically related to the main features of the Dutch pension system.<sup>5</sup> Because of

<sup>1</sup> The proposal (in English) can be downloaded at: <http://www.minfin.nl/dsresource?objectid=72183&type=org>  
<sup>2</sup> Directive 2003/41/EC.

<sup>3</sup> Prepared by Hewitt for the European Commission Research Directorate-General, Final Report 15 June 2010 - Contract n°RTD/DirC/C4/2009/0268794.

<sup>4</sup> See: H. van Meerten, Pensions Reform in the European Union: Recent Developments after the Implementation of the IORP Directive', Pensions: An International Journal, 2009, nr. 4.

<sup>5</sup> For example, Dutch traditional pension funds are prohibited to 'ring-fence'. This means that schemes and the assets belonging to these schemes may not be separated from the whole. Furthermore specific conditions apply to management structure, employee participation and pension fund governance.

these conditions, traditional pension funds are less equipped for international pension schemes.

As a result of the introduction of the PPI the Netherlands will qualify as an attractive location for internationally operating pension institutions. The strong position and tradition of the Dutch pension sector also contribute to this attractiveness. In this respect it is relevant that the Netherlands historically has a very large and solid pension industry (based on a very strong second pillar), with well funded and solid pension institutions. These pension institutions possess a high degree of expertise and experience and a good reputation regarding the management

Furthermore the PPI can be established independent of any sponsoring company or business sector.

A PPI can operate schemes which qualify as pension schemes in the social and labour law of the countries in which these schemes have been agreed. As a result, the pension benefits accumulated in a PPI can eventually – depending on the regulations applicable in the country involved – have various forms: a (temporary) periodic benefit (meaning payment in instalments of the accrued asset over a period in time which has been fixed in advance), a lump sum benefit or a benefit for life.

## As a result of the introduction of the PPI the Netherlands will qualify as an attractive location for internationally operating pension institutions.

of pension capital. Especially the potential for offering a comprehensive pension product to clients (including pension administration, pension communication, ALM-management and investment management) can be considered as an excellent skill. The PPI will enable the Netherlands to effectively export these skills.

### The PPI: main characteristics and advantages

The PPI is a pension vehicle that entirely fits within the framework of the IORP-directive. It has a European passport and can freely offer its services worldwide. A PPI can have the legal form of a public limited company, a private limited company, a foundation or a European company. It is financed on the basis of capital funding (meaning that pay as you go pension schemes can not be operated by a PPI), with the registered office in the Netherlands.

A PPI can deliver the (usual) broad range of pension services. It is not allowed to cover any insurance risks (e.g. biometric risks). As a result, the financial obligations of a PPI consist of the payment to participants of the accumulated pension capital. In the case a pension scheme obligatory must provide for a benefit for life, the obligation of a PPI will consist of a transfer of the accrued pension capital to an insurance company or another pension fund. After all, the PPI is not allowed to cover insurance risks. In such a situation, e.g. in the case of a Dutch pension scheme, a PPI will only be able to operate the accumulation phase. The payment phase of the pension benefits will be exercised by the insurance company involved.

However, the PPI is allowed to operate schemes which entail guarantees that are offered by the employer and/or

by means of – for example – the investment portfolio, whereby a certain investment return is realised.

A major advantage of the aforementioned limitation of the scope of a PPI is that many requirements of the (Dutch) supervisory legislation do not need to be met. For instance, a PPI does not need to fulfil several prudential rules (supervised by the Dutch Central Bank) which are applicable for a common Dutch pension fund, such as the obligations to maintain technical provisions and to meet solvency requirements. Also, no potential recovery plans apply. Thanks to this, a PPI can be set up as a simple, efficient and (as a result) cost attractive vehicle .

Last but not least, the PPI has a competitive tax regime: an exemption from corporate income tax is applicable and, due to its qualification as a resident for tax purposes, a PPI will be able to claim the advantages of the (internationally competitive) Dutch tax treaties network for income and capital gains on its cross border investments. And furthermore the management services of a PPI are exempted from value added tax (VAT). Due to these factors a PPI can be considered as perfectly suitable for the operating of DC-pension schemes and the servicing of the international pension market.

### Conclusion and future developments

By means of the adoption of the PPI by the Second Chamber of the Dutch parliament, the Netherlands has taken an important step in positioning itself as an internationally attractive and competitive location for operating cross border pension schemes of a DC-type. We hope that the First Chamber of the Dutch parliament (the Senate) will also approve the PPI during the coming period and that the PPI can enter into force.

The PPI will not be the only measure of the Dutch government in promoting the Netherlands as an attractive location for IORPs. The next step will be the creation of a so-called General Pension Vehicle ('Algemene Pensioeninstelling, API'). The API will be a vehicle that can also operate international Defined Benefit (DB)- and hybrid pension schemes. Once the API will have been introduced in the Dutch legislation, it will be possible to

operate all types of pension schemes (DB, hybrid, DC) on a cross border basis by an IORP in the Netherlands.

In the context of the recent parliamentary discussions with regard to the PPI, the Dutch government once again has expressed its intention to introduce an API and has announced a timetable for a project of law for an API.

In addition, the European Commission recently published a Green Paper on the future of pensions in the European Union<sup>6</sup>. In this Green Paper the Commission expresses its views on the functioning of the internal market for pensions and the potential role for cross border vehicles in this respect. A main concern of the EU is how to improve the internal market for occupational pension funds and how to remove obstacles for cross border activities of IORPs. Removal of such obstacles will facilitate cross border activities of IORPs, and will as a result be beneficial for the Netherlands as an internationally attractive location for such IORPs.



Hans van Meerten  
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<sup>6</sup> COM 2010, 365.

# European pensions after the crisis



European pension systems face the major challenge of continuing to provide citizens with a decent pension. Most employees are still entirely dependent on 'pay-as-you-go' government pensions that threaten to become unaffordable as a result of ageing. Many governments have therefore implemented reforms, as a result of which public pension benefits will fall by an average of 20% in the coming decades.

Further cutbacks to bring government finances back under control can not be ruled out. Most European Member States have announced increases in the retirement age in order to absorb the effects of higher life expectancies. Although fully funded pensions have developed, as yet only 40% of employees participate in these supplementary pension schemes. Many European countries therefore have to make an all-out effort to achieve coverage of a second pillar with collective pensions.

### Introduction

The Dutch pension system is passing through turbulent times. The funding ratio of pension funds fell from more than 140% in 2007 to 107% in 2010<sup>1</sup>, mainly due to the sharp fall in interest rates, which led to an increase in pension liabilities. On the asset side of the balance sheet, pension assets have risen back to a level above that of before the credit crisis due to the good investment results of the past two years. Nevertheless, life expectancy continues to rise sharply, which places pressure on the affordability of first and second pillar pensions.

There will be considerable debate this year in the Netherlands on future-proofing the pension system. The continual increase in life expectancy calls for adjustments.

<sup>1</sup> DNB, Annual Report, March 2011, Amsterdam, [www.dnb.nl](http://www.dnb.nl).

On the basis of the lessons drawn from the financial crisis<sup>2</sup>, last year employers and employees contracted a Pension Agreement to strengthen the pension system.<sup>3</sup> The 'social partners' (employers' organizations and trade unions) want to increase the retirement age for state and supplementary pensions to 66 by 2020 and then link it to developments in life expectancy. They also want to make the level of supplementary pension benefits more conditional, so that pension funds are better able to absorb shocks in the financial markets. At the same time, pension funds must ensure that the gap with the expectations of pension fund participants is closed. However, these radical measures must not disguise the fact that the Dutch pension system is in many ways in a better position than those of our neighboring countries. Most Europeans are still entirely dependent on the government for their pensions. These pay-as-you-go pension schemes are not directly affected by the crisis, but they are exceptionally vulnerable to the upcoming ageing of the population, particularly since employees in other European countries already retire relatively early. The sharp increase in government deficits

<sup>2</sup> See the Goudswaard Committee, 'A strong second pillar: Towards a future-proof system of supplementary pensions', January 2010, The Hague, and the Frijns Committee, 'Pensions: Uncertain Security - An analysis of the investment policy and risk management of Dutch pension funds', January 2010, The Hague, [www.rijksoverheid.nl](http://www.rijksoverheid.nl).

<sup>3</sup> Labour Foundation, Spring 2010 Pension Agreement, June 2010, The Hague, [www.stvda.nl](http://www.stvda.nl).

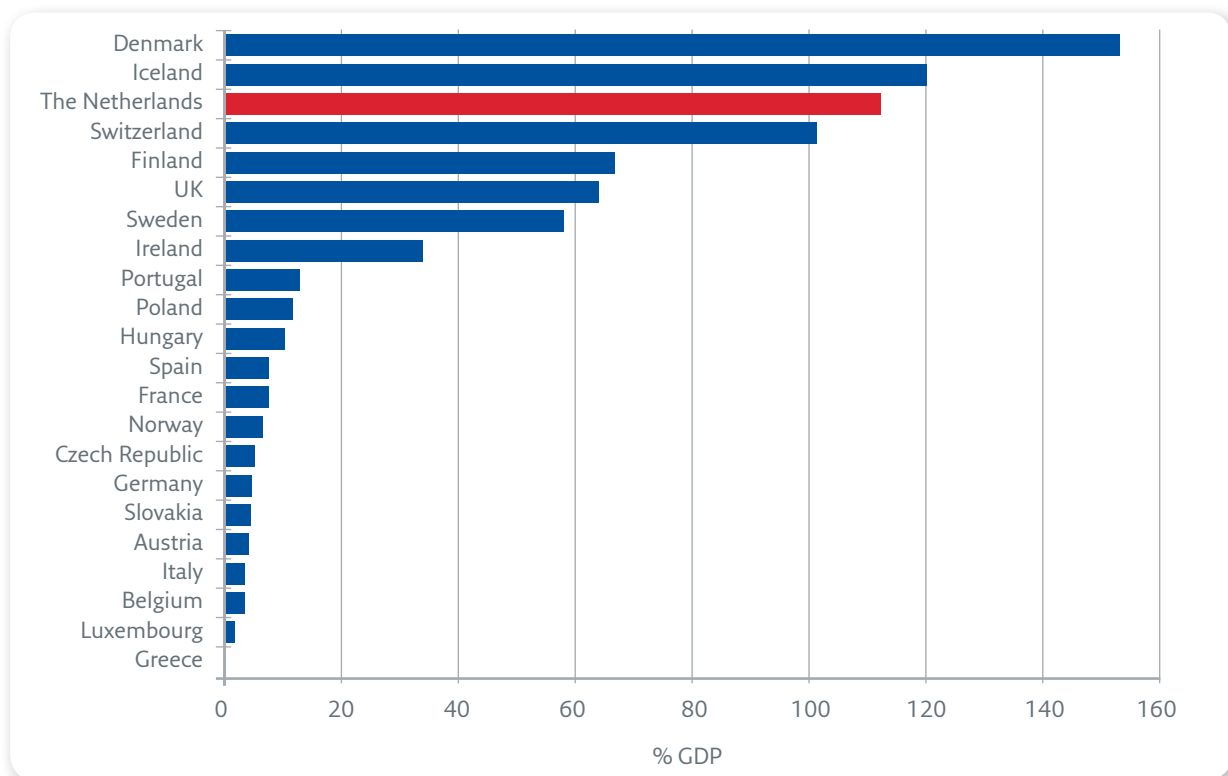
will place further pressure on public pensions. Without further reforms, public pension benefits will prove to be unaffordable in the future. The fact that the Netherlands is in a good position is also shown by the Melbourne Mercer Global Pension Index<sup>4</sup>. As in 2009, according to this survey, the Netherlands still had the best pension system in the world.

The European Commission has recognized the severity of the European pension situation and issued a Green Paper in July 2010 to investigate how Member States and the EU could make their pension systems more future-proof.<sup>5</sup> The fact that other countries will be increasing the sustainability of their pension systems is also very important for the Netherlands. Without that, there is a risk that Europe will pay for its uncovered pension liabilities by

stimulating inflation, which would erode the real value of Dutch pension assets.

In this article, we outline recent developments in European pension systems. Many countries have cut back their pay-as-you-go systems in recent years, which will considerably reduce pension benefits in the coming decades (section 2). Governments have promoted the development of fully funded pensions, but more than half of employees in Europe still have no claim to a supplementary pension scheme (section 3). Participants in individual defined contribution (DC) schemes have been particularly hard-hit by the crisis, but people with pay-as-you-go pensions will also feel the effects of the crisis in the coming years (section 4). Many European countries are working on raising the retirement age in order to absorb the effects of increasing life expectancy (section 5).

Figure 1: Private pension assets, 2008

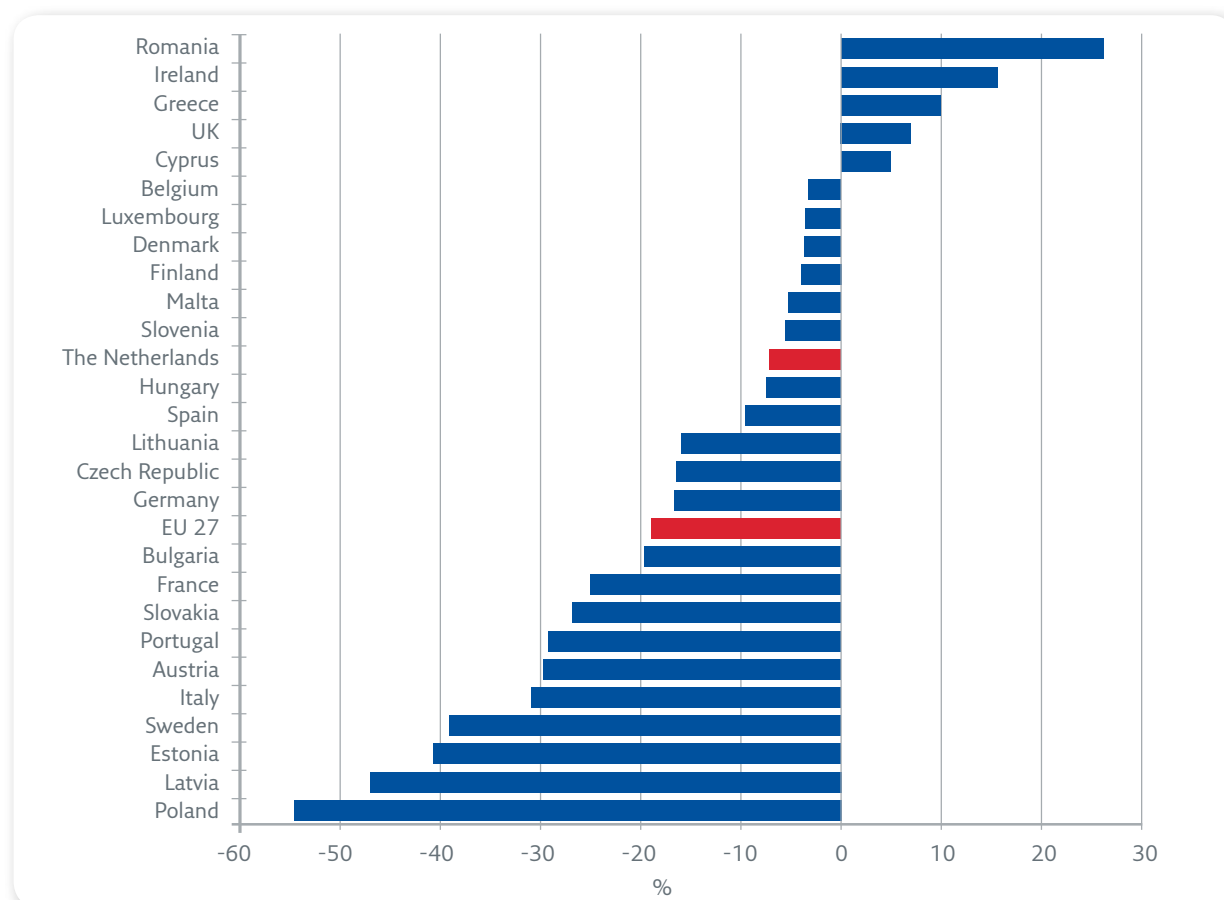


Source: OECD (2010)

4 Australian Centre for Financial Studies and Mercer, Melbourne Mercer Global Pension Index, October 2010, Melbourne.

5 European Commission, Green Paper: Towards adequate, sustainable and safe European pension systems, July 2010, Brussels.

Figure 2: Percentage increase in public pensions, 2010-2060



Source: European Commission (2009)

### Pay-as-you-go systems under pressure

The Netherlands has a balanced spread of pay-as-you-go pensions in the first pillar and fully funded pensions in the second. Countries such as Denmark, Ireland, Iceland, Sweden, Switzerland, and the UK also began saving for pensions at an early stage. The accrued pension assets vary in these countries from 50% to 150% of national income (see Figure 1). In most other countries, employees are still largely dependent on pay-as-you-go public pensions. The distinction between pay-as-you-go and fully funded systems has blurred somewhat now that a number of countries are setting aside funds for part or all of their future pension liabilities in ‘reserve funds’.<sup>6</sup>

<sup>6</sup> See OECD, Pension markets in focus, No. 7, July 2010, Paris, for a review of the reserve funds in eight European countries.

### Ageing leads to lower state pensions

Upcoming ageing places pressure on the affordability of pay-as-you-go systems. In the EU, the ‘dependency ratio’ will double from 26% in 2010 to 53% in 2060.<sup>7</sup> This means that the number of people of working age (15-64) per senior citizen (65+) will halve from four to two. In the future, therefore, two working people will have to raise the pension of each pensioner. Many countries have therefore drastically cut back their traditionally generous pension schemes since the second half of the 1990s.<sup>8</sup> As a result, average pension benefits as a percentage of the average wage will, on average, be 20% lower in 2060 (see Figure 2).

<sup>7</sup> European Commission, 2009 Ageing Report: Economic and budgetary projections for the EU-27 Member States (2008-2060), European Economy 2, April 2009, Brussels.

<sup>8</sup> See European Commission, Interim EPC-SPC Joint Report on Pensions, May 2010, Brussels, for a brief review of the reform measures.

In Denmark, Ireland, and the Netherlands, state pensions consist of a fixed amount. In most other countries, the level of pensions is income-related. The latter often had the character of a final salary scheme, in which the level of benefits was determined on the basis of the wage earned in the final years of the pensioner's working life. Furthermore, the relationship between premiums paid and benefit levels was weak. Employees had an enormous incentive to retire at the minimum age, as working for longer did not result in higher benefits. Cutback measures have strengthened the relationship between premiums and benefits and have made the level of pensions dependent on the average wage during the pensioner's career.

Another popular reform measure is to stop pensions from growing in line with welfare levels. Seven European countries now link pensions to prices and 12 other countries have a form of 'Swiss' indexation, in which pensions are increased by a weighted average of wages and prices. Only in Denmark, the Netherlands, Slovenia, and Sweden are pensions still fully linked to wages. In the Netherlands, the social partners even proposed in the Pension Agreement that in the future, state pensions be linked to wages earned rather than Collective Labor Agreement (CAO) wages alone. In Germany, accrued pension entitlements and pension benefits do follow wages, but a discount is then applied on the basis of the 'sustainability factor'. As a result, pension benefits diminish with the increase in the ratio of pensioners to employed persons. In the notional DC schemes in Italy, Lithuania, Poland, and Sweden, employees build up a notional pension capital. On retirement, this capital is converted into a lifelong annuity, so that in these countries too, higher life expectancy results in lower pension benefits.

### Developments in supplementary pensions

Many countries have started to encourage fully funded pensions in order to offset the reduction in public pension benefits. The EU has also contributed with the introduction of the European Pension Fund Directive in 2003, by offering the Member States an institutional framework for supervision of pension funds. Particularly in southern countries such as Italy, Spain, and Portugal, this has resulted in the emergence of new forms of occupational pensions. But far

from every employee is entitled to a supplementary pension scheme. At present, 40% of employees in Europe participate in occupational pension schemes or individual pension plans made mandatory by the government (see Figure 3).

### Mandatory participation essential for higher participation levels

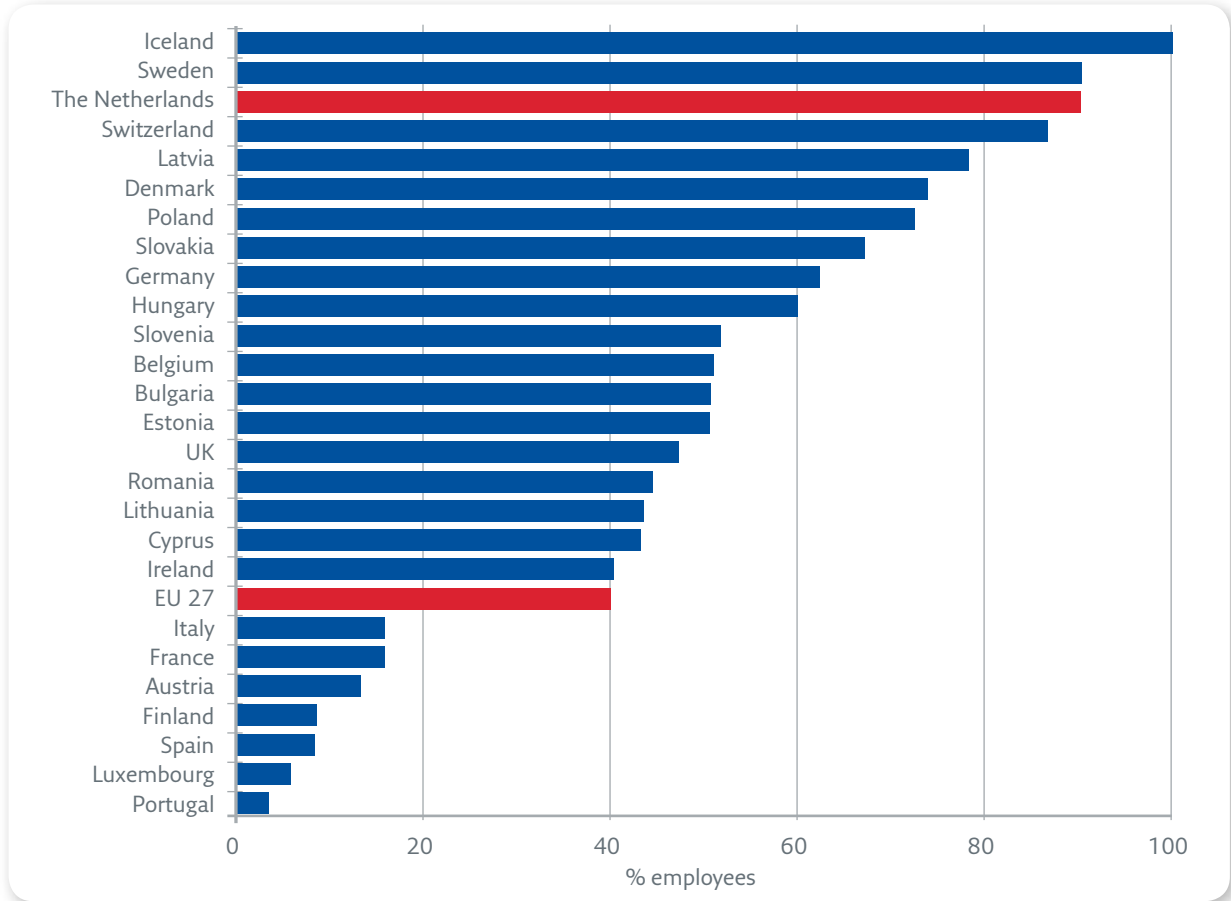
The participation rates in the different countries prove to be heavily dependent on the extent to which the government makes supplementary pensions mandatory.<sup>9</sup> Denmark, the Netherlands, and Sweden are actually exceptional cases, because the social partners in these countries have provided for high coverage in the second pillar via collective bargaining. However, in Denmark and the Netherlands too, the government intervenes by imposing pension agreements in a particular sector on the entire industry.

In Iceland and Switzerland, employers are required to provide for supplementary pensions. Employees are often registered with a group corporate or sectoral pension fund, which show close similarities with the pension funds in the Netherlands. The former communist countries in Central and Eastern Europe, as well as Sweden, have opted for mandatory participation in an individual pension pillar. The government pays the pension premiums to a private pension provider, which the employees can choose for themselves. The exceptions are Lithuania and the Czech Republic, with voluntary participation for employees, and Slovenia, with voluntary company pension schemes.

Italy is the first European country to introduce an auto-enrolment system. After joining a company, employees have six months to choose either the employer's pension fund or an individual pension plan. If the employee does not make a choice, he or she is automatically enrolled in the pension scheme agreed by the social partners. Germany, Ireland, and the UK have the least far-reaching forms of mandatory participation. Companies must give their employees access to a pension scheme, but are not required to contribute towards the pension premiums. From 2012, the UK also intends to introduce an auto-enrolment system

<sup>9</sup> For a review of the different forms, see EFRP, *Workplace pensions – Defined Contribution, Survey, March 2010, Brussels* or The Social Protection Committee, *Privately managed funded pension provision and their contribution to adequate and sustainable pensions, 2008, Brussels*.

Figure 3: Participation in supplementary pension schemes, % of current employees



Source: EC (2008) & EFRP (2010)

and Ireland is making similar plans (see Box 1).

### Trend from DB to DC schemes

In the past decade a strong shift has taken place in Europe from defined benefit (DB) to defined contribution (DC) schemes.<sup>10</sup> An important reason for this is that, due to increased international competition, companies no longer want to bear the risk of restoration contribution and thereby, higher labor costs. The introduction of the international accounting rules (IFRS) reinforced this, as this led to the reflection of volatility in the financial markets in corporate financial statements.

In the UK, the country with the highest pension assets

<sup>10</sup> See EFRP, *Workplace pensions – Defined Contribution, Survey, March 2010*, Brussels.

in Europe, most DB schemes have been closed for new participants or new pension accruals. The new fully funded schemes in the South European and Central and East European countries are all DC schemes. In a number of countries, such as Belgium and Germany, pure DC schemes are prohibited and employers must guarantee a minimum return. More risk has also increasingly been shifted onto participants in Iceland, the Netherlands and Switzerland, but in these group DC schemes there is still intergenerational risk sharing, which has mitigated the impact of the crisis.

### Impact of the crisis

The crisis has placed further pressure on pension provisions in the various European Member States. Fully funded

### Box 1 Anglo-Saxon countries return to collective pensions

The market focus of the 1980s led Anglo-Saxon countries to switch en masse collective pensions to individual pension products. The US encouraged the '401(k)' schemes with tax benefits via Section 401(k) of the tax legislation.<sup>11</sup> In the UK, employees were given the right to leave their company pension funds on participation in individual pension schemes ('personal pensions').<sup>12</sup> In Ireland, too, such pension products account for a large proportion of supplementary pensions.

A major advantage of collective pensions is that they can benefit of economics of scale as a result of which administration and investment costs can be kept low. With collective schemes, high marketing and sales costs can also be avoided. Research by De Nederlandsche Bank (DNB) shows that the costs of individual pension products are seven times higher than those of collective pensions.<sup>13</sup> The effect of these costs on the final pension outcome is very high and is often underestimated. Experience also shows that individuals often take bad investment decisions. In Sweden, for example, employees had a choice of as many as 700

investment funds for individual pension accounts. Only 10% of employees proved to make an active choice and they then opted only for poorly diversified portfolios with relatively high costs.<sup>15</sup>

The UK now appears to be reversing the trend. The government is aiming for a sharp increase in the percentage of employees with supplementary pension schemes, currently less than 50%. From 2012, all employees will automatically build up pensions in their employers' pension schemes (auto-enrolment), while at present they still have to make an active choice ('opting-in'). If the company does not have its own scheme, the employees will automatically participate in the new national pension fund, the National Employment Savings Trust (NEST).<sup>16</sup> NEST will operate a simple defined contribution scheme with few options at low costs. The collective character of the national pension fund enables it to keep the administrative and investment costs low. The pension contribution will amount to 8% of the wage, of which the employer must pay 3%, the employee 4% and the government 1%. The government in Ireland announced in March 2010 that it wishes to introduce the same system.<sup>17</sup>

pensions were visibly directly affected by the falling stock markets in 2008. Investment returns ranged from 1.6% in Germany to as poor as -35% in Ireland (see Table 1)<sup>14</sup>. Differences in investment risk explain this spread. German pension funds make fairly conservative investments with only 25% shares in the investment portfolio, while Irish pension funds have an investment mix with an average of 75% shares. How the reduction in pension assets was translated in individual pensions in Europe depended heavily on the allocation of risks in the pension schemes.

### Participants in individual DC schemes faced a double blow

In a pure DC scheme, stock market fluctuations are directly reflected in an individual's pension accrual. If the stock market falls by 40% and shares account for 50% of

the investment mix, the value of an individual account will drop by 20% at a single stroke. Interest rates at the retirement date are also extremely important, as the accrued pension capital must then be converted into a lifelong annuity. The interest rates thus determine the price of the annuity, with a fall in interest rates of 1%-point leading to about a 10% reduction in the pension benefits. Since stock markets and interest rates often move in the same direction, participants with individual DC schemes run a double risk.

The crisis led to sharply lower pensions for employees with individual DC schemes who were close to retirement. Certainly in countries where a significant proportion of pension income originates from fully funded schemes, the crisis resulted in major intergenerational differences in purchasing power. The OECD calculated for DC schemes

11 See A.H. Munnell and A. Sundén, *Coming Up Short - The Challenge of 401(k) Plans*, Brookings Institution Press, Washington D.C., 2004.

12 See David Blake, *Pension reforms in the UK*, *Economische Statistische Berichten*, No. 4503, 9 February 2007.

13 See J.A. Bikker and J. de Dreu, 'Uitvoeringskosten van Pensioen-verstrekters', in S.G. van der Lecq and O.W. Steenbeek (Eds.), *Kosten en Baten van Collectieve Pensioensystemen*, Kluwer 2006.

14 See OECD, *Pensions at a glance*, 2009 Edition, 2009, Paris

15 See A. Sundén, *How do Individual Accounts Work in the Swedish System*, Issue in Brief No. 22, Center for Retirement Research, Boston, August 2004.

16 For more information, see [www.nestpensions.org.uk](http://www.nestpensions.org.uk).

17 See Government of Ireland, *National Pensions Framework*, March 2010, Dublin, [www.pensionsgreenpaper.ie](http://www.pensionsgreenpaper.ie).

**Table 1: Diminution in pension assets in 2008**

Country	Net return of private pension savings
Germany	1.6%
Czech Republic	0.3%
Greece	-0.9%
Slovakia	-2.1%
Italy	-6.3%
Spain	-8.0%
Norway	-8.7%
Switzerland	-11.3%
Austria	-12.9%
Poland	-14.3%
Luxembourg	-14.4%
Portugal	-14.7%
Finland	-15.0%
The Netherlands	-15.7%
Hungary	-17.6%
Belgium	-19.9%
Ireland	-35.0%

Source: OECD (2009)

in Germany, France, and the UK that the pension income of an average participant who retired in 2008 was about 30% lower than that of a person who retired in 2007.<sup>18</sup> The lower pension income applied here for all the years of retirement. However, pensioners with an individual DC scheme were not affected by the crisis at all. They had already converted their pension assets into fixed annuities, so that their pension income could not diminish. For younger participants, the crisis also led to sharp reduction in pension accrual, but this group is often able to bear the loss because there is still a long time before retirement in which to recover from the blow.

<sup>18</sup> Pablo Antolin and Fiona Stewart, *Private Pensions and Policy Responses to the Financial and Economic Crisis*, OECD Working Papers on Insurance and Private Pensions No. 36, April 2009, Paris.

The exact consequences of the crisis will vary within and between European countries. It is often mandatory for participants in individual DC schemes to invest in accordance with the 'lifecycle' approach, in which the proportion of real assets in the portfolio diminishes with age<sup>19</sup>. However, in many countries participants can have part or all of their pensions paid out as a lump sum, so that they still run investment risks during their retirement.<sup>20</sup> In a number of European countries such as Germany, it is possible to defer the conversion into a lifelong annuity in order to control the conversion risk. The Netherlands introduced similar measures during the crisis. Dutch pensioners were given the option of deferring the conversion of pension assets into a lifelong annuity for a maximum of five years.

### Intergenerational risk-sharing mitigates impact of the crisis

In DB and hybrid pension schemes, stock market fluctuations are not directly reflected in a participant's pension accrual, but are reflected in the pension fund's solvency position: the funding ratio. This funding ratio often serves as the base for sharing the effects of financial shocks between employers, employees, pensioners and future participants. DB and hybrid pension schemes have the advantage that they can achieve intergenerational risk-sharing by spreading surpluses/deficits over time. Pension funds can consequently offer participants a reasonably stable pension income over time.

The funding ratio of pension funds in Europe fell sharply in 2008 (see Table 2)<sup>21</sup>. Irish and Dutch pension funds had particularly striking diminutions of around 45-50 percentage points. In Ireland, this was largely due to the high share of real assets in the pension funds' investment portfolio. In the Netherlands, it was the result of the requirement that funding ratios be calculated on the basis of the current market interest rate (see Box 2).

In the UK, the biggest DB country in Europe, the crisis

<sup>19</sup> See EFRP, *Workplace pensions – Defined Contribution, Survey, March 2010*, Brussels, for a review of the design of DC schemes in Europe.

<sup>20</sup> See EFRP, *Workplace pensions – Decumulation, Survey, April 2011*, Brussel for an overview on payout phase designs in Europe.

<sup>21</sup> See OECD, *Pensions at a glance, 2009 Edition*, 2009, Paris

**Table 2: Movements in average pension fund coverage ratio<sup>22</sup>**

	Year-end 2007	Year-end 2008	Difference
Belgium	130%	115%	-15% points
Finland	130%	115%	-15% points
Ireland	120%	75%	-45% points
Netherlands	144%	95%	-49% points
UK	97%	76%	-21% points
Switzerland	116%	102%	-14% points

Source: OECD (2009)

had no consequences for pensions. UK pension funds are required by law to pay out index-linked pensions. Employers will however have to pay hefty recovery premiums in the coming years in order to restore the financial position. The reduction in coverage ratios also led to almost no reduction in pensions for Dutch average pay schemes with conditional indexation. Only five pension funds with a total of 50,000 participants will reduce pensions by a small percentage as of 1 January 2011. After the crisis, most pension funds did decide not to index-link the pension benefit and a large number of pension funds increased their premiums. The loss of purchasing power for pensioners was very limited, due to low inflation and the increase in income from state pensions. In Switzerland, Europe's third-ranking DB country, the government fixes the minimum interest rate and benefits that pension funds must offer. In order to give the pension funds some breathing space, the government was willing to reduce benefits by adjusting the legal conversion factor at retirement, but the population rejected this proposal in a referendum. The minimum interest rate for accrued pensions was reduced, however. Swiss pension funds also have the option of not increasing pensions that are already being paid out.

### Pay-as-you-go pensions trail still further

At first glance, countries in which pension provisions

consist largely of pay-as-you-go state pensions do not appear to have been affected by the crisis. After all, falling stock market prices do not affect the level of state pensions. However, the crisis does affect pay-as-you-go state pensions in the longer term.

The crisis placed severe pressure on government finances in many European countries. Government deficits have risen sharply and the average national debt approached 100% of GDP. The European Commission calculated that in the coming years, government will have to make cuts of 6.5% of GDP – as much as EUR 800 billion – in order to keep government finances manageable.<sup>23</sup> Certainly in the long term, cuts in pay-as-you-go pension schemes contribute towards an improvement in government finances. It is certainly not ruled out that public pensions in Europe will trail still further.

### Pension assets a target in order to close budget gaps

A substantial number of countries have taken measures that improve government finances in the short term, but that jeopardize the sustainability of pensions in the long term. France decided to use the EUR 33 billion reserve fund for public pensions (Fonds de réserve des retraites) to cover current expenditure. In Ireland, the National Pensions Reserve Fund, with assets of EUR 24 billion, first had to contribute 6.5 billion to support failed banks and then EUR 10 billion to the rescue plan for the Irish government. In Portugal, the pension funds of Portugal Telecom and the banking sector were nationalized. Both sectors have always been responsible for providing pensions in the first pillar themselves.

Governments in Central and Eastern Europe have set their sights on mandatory private pension savings. The Hungarian government, for example, has halted premium payments for the individual accounts of participants. The government also encouraged everyone to transfer existing pension savings to the first pillar. This conversion took place automatically, but participants were given the opportunity to opt out. However, this means that they can no longer make any claim to a state pension, which

<sup>22</sup> Figures of different countries are not easily comparable, as each country uses a different method to calculate coverage.

<sup>23</sup> European Commission, Sustainability Report 2009, European Economy 9, September 2009, Brussels.

### Box 2 The Netherlands an exception with market valuation

Roughly half of the fall in the coverage ratio of Dutch pension funds in 2008 was attributable to a reduction in assets. The other half was the result of an increase in liabilities due to the sharp decline in interest rates. The Financial Assessment Framework (FTK) requires pension funds to discount their liabilities with the nominal interest term structure, which is derived from the interbank swap interest rate. Because this rate fell sharply, the market value of the pension funds' liabilities increased.

As a result of these rules, collective pensions as well as individual pension schemes are sensitive to interest rate movements. The big difference, however, is that collective pension schemes suffer in accounting terms from low interest rates (in reality, they do not pay out a single euro more or less), but that this does not play a role in the actual pensions to be paid out. For individual pensions, interest rates on the conversion date do play an important role in the amount of the pension benefits.

A number of other European countries, such as Denmark and Sweden, also use the risk-free market interest rates to discount liabilities. Most European countries with many group pension funds use different discount rates. Ireland, the UK, and

Switzerland, for example, use the expected yield and/or the yield on corporate bonds as the discount rate. These lie above the risk-free interest rate. In Germany, by contrast, a fixed notional interest rate is used that lies below the level of the risk-free rate.<sup>24</sup> In the UK, a distinction is also made between corporate and state pension funds. Corporate pension funds value their liabilities in accordance with the IFRS rules, on the basis of high-rated corporate bonds (at least AA) with a premium of 150 to 200 basis points, while public funds (county or municipal) use the expected yield with a premium of 250 to 300 basis points. The total discount factor for these schemes is around 6.5 to 7%. The guiding principle for this valuation system is the sponsor's continuity risk.

The main objection to the current discount rate in the Dutch FTK is that it is very volatile and works pro-cyclically. As a result, it is difficult for pension funds to concentrate on their long-term objectives. It is notable that the recently published Green Paper opposes pro-cyclic supervision rules for pensions. In the OECD economic survey<sup>25</sup>, the OECD put forward a number of alternatives for the valuation of Dutch pension liabilities. A fixed notional interest rate, a long-term average of the risk-free rate and the interest on high-yield (AA-rated) corporate bonds or government debt, with or without a premium, are mentioned as possible alternatives.

was an unattractive option for most Hungarians. Poland, too, is targeting pension savings as a bailout for government deficits, albeit in a less rigorous manner than in Hungary. Polish pension institutions will no longer receive part of the (mandatory) pension premiums direct, but in the form of 'pension bonds'. The Polish government need not redeem these pension bonds until a person actually retires. This reduces the costs for the Polish government in the short term and, as in Hungary, the bill is deferred to a future date. After the pension reforms of the past decade, these countries now appear to be back where they started.

### Higher retirement age in Europe

Increasing the retirement age is an effective way to increase the sustainability of pay-as-you-go systems and absorb rising life expectancy. It reduces government expenditure

without limiting the level of pension benefits and increases tax revenue because employees continue working for longer. In most countries, the retirement age serves as the reference for determining a full pension. Employees can often retire early with lower benefits, or later with higher benefits. Only in countries where state pensions consist of a fixed amount (Denmark, Ireland, and the Netherlands) is the commencement date the same as the retirement age. The average retirement age in Europe is currently just 61, two years lower than in the Netherlands.<sup>26</sup>

<sup>24</sup> See CEIOPS, Survey on fully funded, technical provisions and security mechanisms in the European occupational pension sector, 31 March 2008, Frankfurt.

<sup>25</sup> OECD, OECD Economic Surveys: Netherlands, June 2010, Paris.

<sup>26</sup> See European Commission, Interim EPC-SPC Joint Report on Pensions, 28 May 2010, Brussels.

## Number of retirement years varies considerably within Europe

In which countries do people enjoy pensions longest? Figure 4 shows the duration between the average retirement age in 2008 and the expected date of decease. It is not said that people will receive pension from the age when they stop working, but they do have to live on something. Generally, there are often other schemes, in addition to the official pension, that make early retirement possible and that also cost the state money. This means that the countries with the longest 'retirement duration' can expect the biggest problems. It can be seen that France has the longest retirement duration, on average more than 25 years, followed by Romania and then Italy. Romania is notable for the low average age of 55.5 for stopping working. The retirement age is 63 years and eight months for men and 58 years and eight months for women. The Netherlands, with a modest average of some 20 pension years, is among the countries with the shorter durations.

### Increase in life expectancy not yet at an end

The increase in life expectancy is far from reaching an end. The remaining life expectancy after the age of 65 will increase further in all EU countries (see Figure 5). The leading collective for long life currently consists of

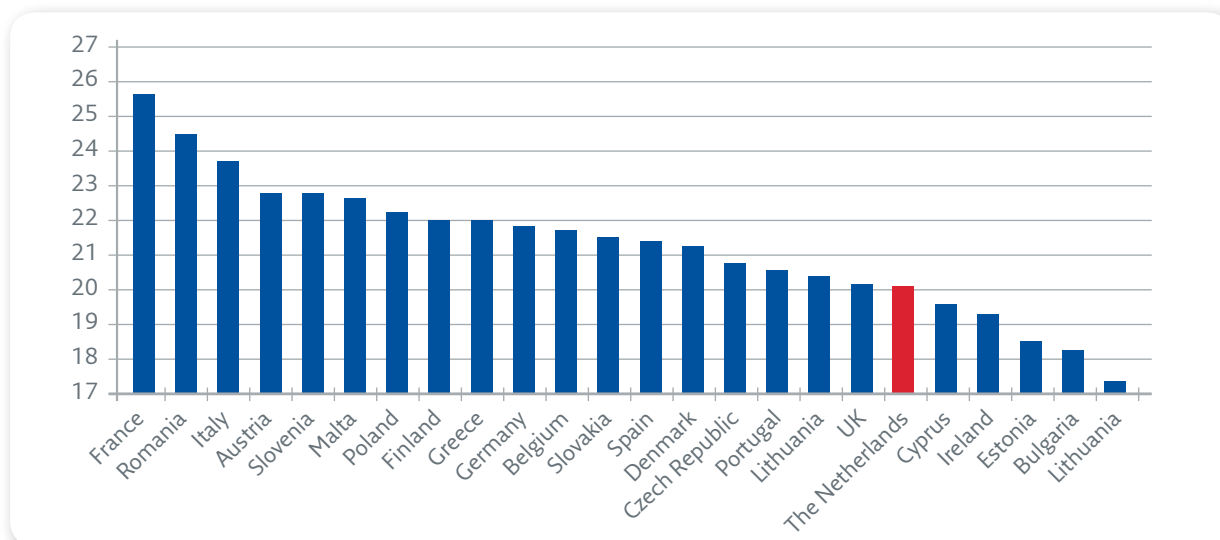
the South European countries, while those in the group with the shortest life expectancy are without exception Central and East European countries, with the North and West European countries forming the middle band. The Netherlands ranks 12th, between Ireland and the UK. The expected trend shows a clear convergence in life expectancy. The anticipated growth is highest in the Central and East European countries.

### Majority of European countries raise retirement age

More than half of the EU Member States have announced measures designed to lead to a higher retirement age in 2020 (see Figure 6). There are also countries that have announced measures for after 2020. In the Netherlands, Italy, and Denmark, for example, the retirement age will rise in line with life expectancy. An increase in the retirement age from 65 to 68 is also expected in the UK, partially covering the period after 2020. In the above figure, we focus on 2020, to see which countries are taking action in the 'near' future.

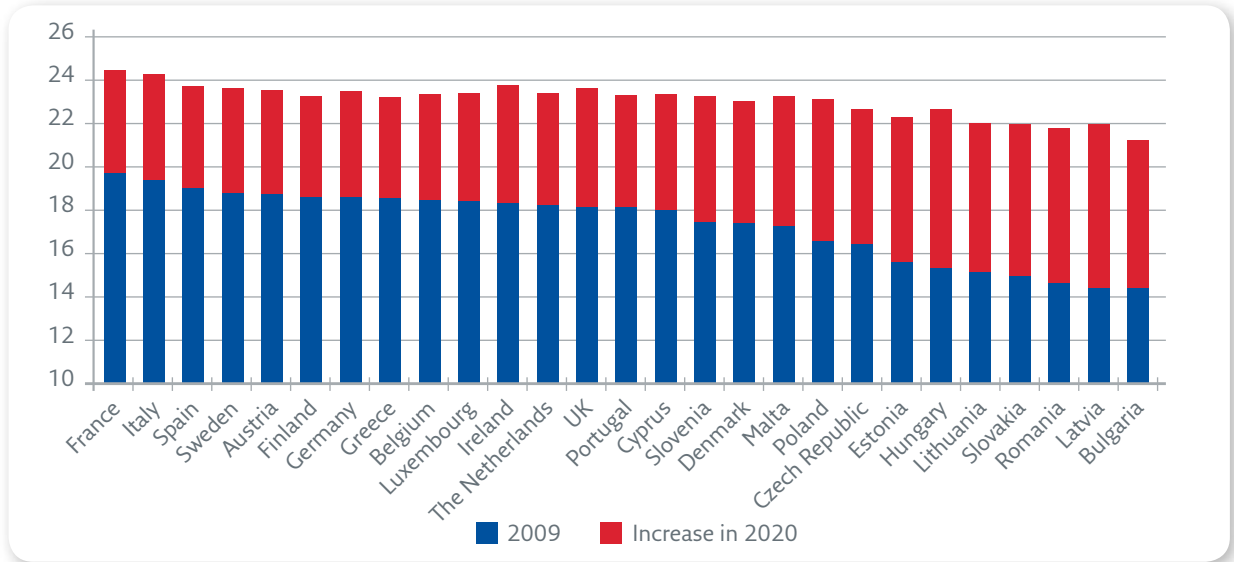
The countries with the lowest retirement age (Malta, Slovakia, Romania, Lithuania, and the Czech Republic) intend to increase their retirement ages before or in 2020. In view of the expected increase in life expectancy,

Figure 4: Average duration of retirement pensions



Source: Own calculations based on European Commission

Figure 5: Life expectancy after the age of 65 in 2009 and increase until 2060



Source: European Commission

this is wise. The countries with the highest life expectancy (France, Italy, and Spain) also intend to increase their retirement ages. The proposal in Italy is to link the retirement age to life expectancy on a structural basis. This reform was adopted by Parliament in July, with little publicity. As a result of the reform, the Italians are expected to have to work for three extra years in 2050. This year, the retirement age for female civil servants has already been raised from 60 to 65. This was imposed in June by the European Court of Justice. From 2012, female Italian civil servants, like men, must continue to work until the age of 65. They will then no longer be able to retire at 60 as at present, or, as often happens, as early as 56. Italy did not wish to repeal the unequal treatment of men and women until 2018.

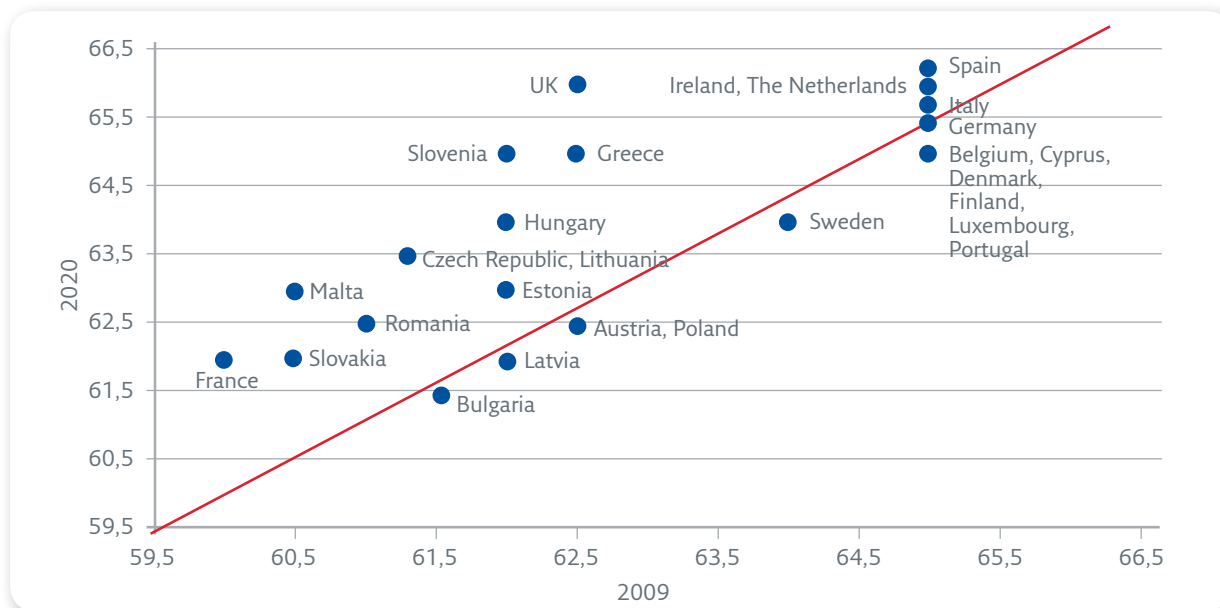
It is notable that many countries have only recently taken the decision (or announced the intention) to raise the retirement age. The financial crisis and the pressure it placed on government finances was a strong stimulus to implement reforms for the structural ageing problem.

The four countries that currently have the highest retirement age, of 65, have also announced that they will increase this. These countries are Denmark, Germany,

Ireland, and the Netherlands. The Danish government announced in 2006 that it will raise the retirement age to 67 between 2024 and 2027, and if life expectancy rises further after 2024 the retirement age will be allowed to rise with it after 2027. In Germany, the retirement age is being increased in stages. The retirement age will increase by one month in 2012. Thereafter, the retirement age will increase every year, first by one month and later by two months, to reach 67 in 2029. The UK is also raising its retirement age. The average age is increasing for two reasons. Firstly, the difference between men and women is being repealed. Women can currently retire at 60 and men at 65. The figure is based on the average. The age will also increase to 66 between 2018 and 2020 and will then rise further, to 68.

Nevertheless, there are still countries that are not (or not yet) planning to change their retirement ages in the years to 2020. These include countries with a relatively low retirement age, such as Bulgaria and Latvia, but where a sharp increase in life expectancy is anticipated. It is notable here that the retirement age differs for men and women in Bulgaria. Men can retire at 63 and women at 60. In view of the higher life expectancy for women, this will lead to an enormous redistribution and pressure on government

Figure 6: Retirement ages\* in 2009 and 2020 in EU 27



Source: European Commission and own research  
Where applicable, the average for men and women and for time intervals is shown.

finances. However, no country will reduce the retirement age in comparison with 2009, which is not surprising.

### Conclusion

Last year the European Commission published a Green Paper in order to arrive at adequate and sustainable pension systems in Europe. Sustainable pension systems are vital to prevent government debt from running out of control, which would form a serious threat to economic stability in Europe. At the same time, meagre pensions threaten to place pressure on sustainability as future generations demand better provision for old age. In many Member States, employees will therefore have to work for longer via substantial increases in the retirement age. Furthermore, governments will have to encourage widespread participation in a fully funded pillar of group pensions. These enormous European challenges reduce the Dutch pension debate, in the words of former Minister of Social Affairs and Employment, Piet Hein Donner, to ‘no more than maintenance for the preservation of a sound and robust pension system.’

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