

## *Speech Else Melbourne; The Dutch pension system on the move*

Ladies and gentlemen,

I would like to thank the organising committee of the 2011 Melbourne Financial Services Symposium for giving me the opportunity to speak to you about developments in the Dutch pension fund sector.

When I accepted the invitation to speak today on this topic I thought this would be easy. Just tell you a bit about the great Dutch pension system, how difficult can that be.

But in preparing this speech I could only conclude that we have made it all very complex.

And to be honest, I think that is one of the reasons why we, the Dutch are where we are today. What cannot be easily explained will not be appreciated by everybody.

I hope I will do better than just get you very confused.

As a start I would like to give you some insights into the developments in the Dutch pension sector. The recent financial crisis has indicated that we have to discuss the sustainability of the current structure of pension contracts in the occupational pension sector.

In The Netherlands we are of the opinion that we have a unique pension system, but due to the fact that people in general live longer and because of the aging of society, the current pension contracts in The Netherlands need to be revised to withstand demographic changes and volatile financial markets.

An important element in these discussions is whether we can maintain the solidarity in the system to share the risks between different groups and generations.

In this presentation I will (if I have time) also elaborate a bit on recent thoughts we as an organisation have on the possibilities to connect the pension domain with other domains like healthcare and housing. We call this the project the "New Old Age".

Let me start with giving you some of my background; who is PGGM?

PGGM is a Dutch pension delivery organisation with a cooperative structure. We are responsible for managing several pension schemes. At PGGM we have approximately 1000 employees.

Our largest institutional client is the Dutch Pension Fund for the Healthcare and Welfare sector. In addition we service 4 other Dutch pension funds with combinations of asset management and pension administration.

As a pension services provider, we are responsible for both the pension administration and the asset management. Furthermore we provide managerial and policy support for the Board of Trustees of the different pension funds.

We cover the pensions of over 2 million people. We manage over 100 billion euro AUM.

PGGM is a not for profit member organisation. Apart from the institutional activities PGGM offers additional financial products and advice. These products are offered collectively through the employers, as well individually to our members.

The members of our cooperative -- the employers, employees and pensioners, (through the members council and board,) -- are in the position to co-develop our retail-product line and have an influence on strategic decisions of the company. For PGGM, making profit is not a goal as such, but when it occurs we use it to improve service for our clients and members.

As a final characteristic, I would like to add that corporate governance and responsible investments are second nature to us. PGGM believes that financial return and responsibility towards civil society should and can go hand in hand. Therefore environmental, social and governance standards play an important role in our investment decisions.

#### Our Dutch model

The Dutch pension model can be explained with the so-called 'cappuccino model' In the Netherlands we have a flat rate pay-as-you-go state pension as a basic income from the age of 65. On top of that we have a 2<sup>nd</sup> pillar of funded occupational pensions. In the third pillar individual members can make additional savings if they want to further increase their pension.

In this presentation I will concentrate on the 2<sup>e</sup> pillar. Even though the first pillar is under discussion as well. Retirement age is expected to go up for state pensions over the next coming years.

#### Supplementary (occupational) pensions in more detail

The Dutch have about 600 pension funds, with around 750 billion euro AUM (this is roughly 1000 billion AUD).

90% of the Dutch employees participate in these pension funds on a compulsory basis.

The replacement rate of the Dutch pension funds is around 80% of average pay, for participants that have worked 40 years. Most funds have the ambition to provide compensation for wage inflation to the pensions. The official retirement age is 65, but the average retirement age is now around 62/ 63. The pension contributions are in most cases around 20% of salary. The average asset mix for a Dutch fund is 50% invested in equities and 50% invested in bonds, but with many varieties around this.

Our occupational pension system is organized in a collective way and membership is mandatory for the workers of a company or an entire sector where such a collective agreement exists.

In terms of Assets Under Management more than 90% of the Dutch pension fund sector has a Defined Benefit system in which risks are shared among the participant.

#### Mercer: "Netherlands best pension system"

The Dutch pension system holds the first place in the Melbourne Mercer Global Pension index. Of course we are flattered by such a high score and we are proud of our system. But

never the less we realize that our pension system needs to develop further, to make it robust for financial shocks and sustainable for the future.

#### Funding ratio volatility

Like all of us, in 2008 Dutch pension funds were confronted with negative investment returns causing a decrease in pension assets. The Dutch regulatory system is based on a fair market value approach of the assets and the liabilities. Therefore, the decrease in interest rate yield also caused an increase in the value of the pension liabilities. The result was a double negative effect on the funding ratios of the Dutch pension funds.

The financial crisis has accelerated the discussions about the robustness of our pension system. In fact, this discussion was already going on for several years.

The financial crisis as such is not the real problem, but it made the underlying fundamental questions and dilemma's about the viability of the system more apparent.

What is the issue? Why should we reconsider the fundamental building blocks of our pension contract?

The recent crisis has exposed bottlenecks in the current system, and has given the industry limited room to maneuver.

That is why the Dutch pension system is currently on the move towards a new pension contract that should be sustainable for the future.

In the remainder of my presentation I will elaborate on the current discussions around the design of a new pension contract in The Netherlands. These discussions can be summarized around 5 topics or issues if you like

1. The tension between the nominal guarantee and the indexation ambition in the current Defined Benefit contract
2. The longevity risk, how to make the contract robust for this phenomena
3. The aging of society, should it impact the structure of the contract
4. Communication around pensions, are people aware of the risks in the contract and do they accept them
5. a mandatory system: is it still appropriate in current society?

I will explain the dilemma's and share the possible solutions with you. Just to be clear, no decisions are taken yet. Stakeholders are still in the heat of the debate.

1. The Dutch Defined Benefit contract holds a formal nominal guarantee but also an indexation ambition. Unfortunately they are inconsistent.

The Dutch DB pension contract has a combination of a nominal guarantee, based on the average pay during the labor period, and at the same time a real terms ambition to index the pay-out in order to compensate for labor cost inflation. This is a very attractive combination for members of the pension fund.

The current regulation is based on a nominal framework, with the nominal coverage ratio as the key indicator.

This combination creates conflicting messages for the investment policy: to manage the nominal coverage ratio the investment risk should be limited, with a preference to invest in nominal bonds.

But to manage the indexation ambition, a different asset mix is needed, with higher percentages allocated to real assets such as equities, inflation linked bonds and real estate. To fulfill the real ambition we put the guarantee at stake or vice versa. A difficult choice for the trustees.

There is also a discussion about the right discount rate to calculate the value of the liabilities. The current contract holds an unconditional nominal guarantee. For that reason it uses a risk free market rate as the discount factor for the liabilities.

Due to the conditional character of a real pension contract the pension sector argues that the current risk free (real) market rate is not the right discount rate. The proposal is to use a combination of a market rate with a risk add-on. Or expected portfolio returns after inflation, which would reduce the volatility of the liabilities.

Another development that plays an important role in the discussions around a new pension contract is the changing demographics. It comes in two ways: on the one hand we keep on living longer, on the other hand we see an aging population.

## 2. Longevity

Recent changes in the mortality tables have resulted in an additional liability of EUR 40 billion for the whole Dutch pension sector. The fact that people get older and older results in higher costs of the pension promise. And if no other measures are taken, it would require a big increase in the premium paid for pension. Where we currently pay about 20%, which is felt as the maximum.

If we would want to keep the pension age where it currently is, we would have a problem with the affordability of the system.

## 3. Aging

The other phenomenon that causes a drastic change in demographics is aging. The babyboom generation is squeezing through the population pyramid, resulting in a pyramid that is getting higher and wider at the top. This phenomenon especially has an impact on the first pillar that is funded as a pay-as-you-go system.

But also in the second pillar we see a negative impact due to changing demographics.

First, it is getting more difficult to steer the fund with pension premium contributions as the ratio between premium income and pension rights is decreasing. This means that more premium income is needed for a recovery of the funding ratio.

The ability of premium income alone to manage the fund is getting less effective.

Second, the nominal guarantees that have been communicated limit the flexibility of the fund to absorb losses. A decrease of pensions would especially have an impact on the older members who are close to retirement and always have assumed a pension guarantee.

Sharing risks between generations is an important element of Dutch pension funds. By spreading risks over multiple generations, the impact of these risks will decrease for each individual generation. However, this intergenerational risk sharing will only work if there is continuity of the fund.

Therefore it is important that future participants of the funds will not be disadvantaged by the expectation that they absorb excess risk because if they perceive such an imbalance they will not be willing to join the system. So intergenerational risk sharing is beneficial for the system,

#### 4. Communication, pension awareness

Pension awareness and understanding is a challenge in the Netherlands. What makes communication difficult is that the pension contracts have become very complex and difficult to explain.

The consequence is that the communication of the pension funds so far was very simple and limited. The funds hardly talked about the risks in the pension system and thus were not as transparent as they could have been, for instance about the investment risks. The funds have to make sufficient returns and take a certain amount of risk in order to ensure that future pensioners will also get a adequate and affordable pension.

In principle there is no problem with that. But funds barely communicated about those risks, which are borne by the (future) members and their employers. The crisis made things clear for the Dutch public. Risks became real and the broader public is involved in the debate.

Now that people are more involved, another difficult question rises. People tend to think in nominal terms but their risk is in real terms. The consequence is that a cut in nominal pension rights is perceived worse than a decrease in indexation. This also creates a communication issue.

People have a money illusion they underestimate the impact of lower indexation, and overestimate the impact of a cut in pensions: 5% inflation with 1% indexation has a bigger negative impact on your purchasing power than a situation with 1% inflation and a cut in pensions of 1%.

However, members of a pension fund don't see the first scenario as a problem, as they do for the second scenario.

#### 5. Mandatory pension system

In The Netherlands we have a mandatory pension system. As an employee it is mandatory to join the pension system and it is mandatory as well to use a specific pension fund for your sector or company.

This system has proven that it has significant added value:

- There is a wide pension coverage in The Netherlands
- We have a cost efficient system
- And the mandatory system has facilitated the intergenerational risk sharing and continuity of the Dutch pension system.

However, the lack of choice creates unease with members and puts additional pressure on the system. Specifically in difficult times.

So, a great system with some serious challenges. What can we do about them.

Possible solutions for these dilemma's

The consequence of all the above mentioned dilemma's is that we have to make explicit choices for the pension contract of the future. The dilemma's I just described have their own specific solutions:

## 2. Longevity risk

In The Netherlands the social partners (the employer and employee representatives) have recently agreed that an increase in life expectancy can no longer result in an increase in pension premiums.

As a solution they are now reconsidering the retirement age. The first and the second pillar both are likely to push retirement age to 66 in 2012 and 67 in 2017.

It is possible that this change will not only affect the buildup of new pension rights, existing pension rights may also have to be decreased in the future when we live longer.

These steps are very important for the sustainability of the pension contract. However, this is new for the members of the pension fund who were used to guarantees regardless of the increase in life expectancy.

Additionally we are also investigating whether longevity bonds could be an instrument to transfer the risk to the capital markets.

## 3. Aging

The challenge is to find the right balance for the different generations. This is exactly the discussion we currently have in the Netherlands between the different age-groups. This discussion puts additional pressure on the solidarity within the system.

The aging population creates yet another dilemma. As the average age of the members of the fund increases the group of older members will grow and become more influential. The result could be that younger employees will have no choice but to join a fund that has a very defensive investment approach that is not desirable at their stage of life.

One potential solution to this issue is to decrease the investment risk. In this way there is less risk to share between generations. But less risk also means a lower investment return that will result in either a lower pension or a required increase in pension premiums. This creates a dilemma on the investment side: due to the aging population the fund should in fact decrease its investment risk, based on the assumption that the fund has one investment mix for all members of the fund.

Another possible solution would be to split the fund into a group of younger or active members, and a group of older or retired members, and manage the fund differently for these two groups.

This would be a drastic change from the past, but is perhaps the only way to create a satisfying investment mix for the different groups. There is currently only limited support for this idea, but further studies are encouraged.

#### 4. Communication

Both increased awareness and involvement are some of the very few good things that came out of the crisis.

We decided with our clients to change the communication strategy drastically and to be more transparent in all aspects. We streamlined the communication tools and organised events in different regions of the Netherlands.

During these events, together with our clients, we discussed the actual situation with the members of the Health and Welfare pension fund and communicated about the risks involved in the pension and asset management activities.

We are determined to continue on this path of transparency in the communication strategy for our clients. (on their instigation of cause)

Also a large communication campaign is currently organized by the Dutch Pension Federation to inform Dutch society about the characteristics of the pension system. Communication will focus more on what people can expect in the future regarding their pension.

Pension communication has also an increasing interest from the Dutch supervisors. They are very concerned by the lack of understanding people have on their personal financial situation in the future and the uncertainties around it.

#### 5. Mandatory system

Currently the Dutch pension system only provides choices in the decumulation phase at the moment of retirement. The issues I described are becoming clear to a broader public. Negative incidents the last years are causing an unease with members of the pension funds because of the lack of choice. They are not able to make their own decisions with respect to their pension savings.

For the future we expect further discussions for choices in the accumulation phase where members might get the option to make choices about for instance different risk profiles or the level of pension premium.

It is my expectation that in the Netherlands we will not, at this point in time, go that far as to give individual members the choice of which pension fund provider to choose, or provide the flexibility that the Australian Supers provide to their clients.

But if the Dutch pension system moves in that direction we are definitely interested to learn from your experience in giving more freedom of choice to members of pension funds.

Finally, the most difficult dilemma, New pension contract for the future.

We need to solve the tension between a nominal guarantee and a real ambition. At the moment the stakeholders are discussing three scenario's for a better pension contract:

If we would choose a fixed nominal guarantee (on the left side on the slide), we have to deliver on our promise and execute a matched investment strategy with mainly bond investments. In this way we accept that the pensions do not increase with inflation, and the fund members run a purchasing power risk.

The alternative is that we keep focusing on the real ambition (on the right side of the slide). In that scenario we continue taking investment risks and accept a mismatch between the assets and the nominal liabilities. In that situation we maximize the chances for a real pension with indexation.

However, we do know that investing involves risk-taking, and that the risks cannot be constantly postponed to future generations. The consequence is that the pension payout is conditional. If the funding ratio of the fund is too low, this will result in a lower pension promise.

In the middle of the slide you see a combination of these two alternatives. The basis is a fixed nominal guarantee, with the remainder of the available capital invested to realize the indexation ambition.

The discussions around the new pension contract are currently in the final phase. The conversation is leaning in the direction of the fully adjustable real contract; a so-called Defined Ambition contract (so the alternative on the right hand side of the slide).

Important elements in the discussion are:

- Wish to maintain the collectivity, solidarity and mandatory elements
- No differentiation between generations at this point in time
- Regulatory framework should be more focused on real terms
- Communication should be focused on real terms

We expect these discussions to be finalized over the next coming weeks. Timely decisions are needed as the aim is for the new pension contract to be active on January 1<sup>st</sup>, 2012. A new contract will need substantial investments in time and resources in the remainder of 2011 to be able to implement and administer the new contract.

Let me conclude:

As I mentioned at the start of my presentation, I think we still have one of the best pension systems in the world.

However, maintenance to the system is required to insure the sustainability of the system.

The key issues hereby are:

- The choice between a nominal or real framework
- How to treat and incorporate the longevity trend
- How to embed the demographic development of ageing
- How to increase transparency and improve communication.

As I just described, a number of possible solutions is currently under discussion. This is a time consuming process as it impacts the core of our pension system. Employers, employees, academics and politicians are involved. The Dutch have to come to a decision shortly.

Pension Innovation: New Old Age

Let me finalize with giving you some insights around how we as an organization look at the pension product going forward.

Recently we at PGGM have started a pension innovation process where we are looking at the future of pensions in a somewhat different way.

One of our thoughts is that in the future pensions will not just be about money. Other needs, like healthcare and appropriate housing will become more and more important.

The elderly people of tomorrow feel different and younger and have increasing expectations for both themselves and for their social environment.

Future elderly people have built up a higher income and have generated more assets in their house and supplementary pensions.

But they expect that the public domain will decrease. Public arrangements will become less reliable. As a result, people will pick up the responsibility themselves and will make arrangements on their own. These arrangements will be on the crossroads of Pensions, Healthcare and Housing. We call this the New Old Age

Just one example: People will ask themselves: Will there be enough people in my life and available in the healthcare system to provide me with the services I might need?

- In the near future the main issue is the attainability of health services and care and not just the availability of money.
- Because money alone does not provide a sufficient guarantee for a good old age, welfare and social wellbeing are more important than wealth. Especially at an advanced age, a safe, pleasant and inspiring living-environment is crucial.

The domains of pensions, healthcare and housing share similar life-cycle developments that move from building up (or saving) when you are young, to a period of withdrawal when you are older.

The pension-domain was primarily financial capital, But we must not forget that the human capital is also an important part of the pension-domain.

The financial capital is built up using the human capital. It has to be in balance.

That's why we are looking into integrated pension products together with healthcare, housing, welfare and wellness.

What is necessary to achieve this kind of thinking about flexibility among the domains and over the lifecycle?

First a consistent government policy is necessary.

Second, legislative regulation needs to adapt to facilitate that flexibility among the domains and over the lifecycle.

Third, we cannot do it on our own. We believe that new alliances can bring change. That's why we search for partners in the other domains. This combined knowledge can lead to new pension products.

Cooperation and making connections with other institutions are the key-words here.

It is a new thought, we intend to further develop over the next years.

Ladies and gentlemen

I would like to conclude by saying that the pension fund industry is in a very interesting phase right now.

The system we used to know is under pressure to adapt to demographic developments and more volatile financial markets.

In The Netherlands we will try to keep our principles of solidarity and collectivism in place as long as possible.

But the pressure is growing to move to more individual choices. In this respect we can learn from the Australian experience.

At PGGM we want to contribute the process of innovation and assist people to create a valuable future for themselves.

this could result in a future pension contract that is more than just a financial contract, but that also combines healthcare, wellness and housing solutions.

When we are further along in developing these types of pension products I would be pleased to come back and inform you accordingly.

I Thank you for your attention!