OECD conference on pension reform in Russia

Moscow, 24 -26 September 2003

Pension system and supervision
(Room Document N°4, Session 3)

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Agenda

- Options and choices
- The case for the second pillar
- Second pillar supervision choices
- Suggestions

Options and choices

When you come to a fork in the road, take it.

Yogi Berra

Choosing

- Immediate international agreement
  - My neighbor's pension system will collapse
  - My pension system is the best in the world
- There is no perfect system!
  - Choose according to what fits you best
- Honesty in advertising, the Dutch system
  - Three pillars (PGGM is a second pillar fund)
  - Defined benefits dominate
  - 70% of workers participate in compulsory, industry-wide funds
  - Bipartite organization, self-regulation

Objectives

- Employers want to be competitive in the market
  - Attractive salary package (reasonable pensions, low risk)
  - Reasonable wage cost (low premiums)
- Employees want a cheap, but reliable pension
  - Low premiums
  - Low risk, reasonable pensions
- Governments want to maximize people’s welfare
  - Reasonable pensions
  - No surprises (obligations are met, no squandering of savings)
  - No guarantees or safety net necessary

Checks and balances

- How is the premium charge divided?
  - Government (P.M. tax concessions)
  - Employers
  - Employees
- How is risk divided?
  - Systemic and political risk (Government? Supervisors?)
  - Any investment risk (Sponsor? Members?)
  - Inflation risk (Pension fund?)
  - Demographic risk (long life) and intergenerational risk
- P.M. Division of labor between pillars

The case for the second pillar

The day you retire is the first day
of the rest of your life's savings

Anonymus

Second pillar fund characteristics

- Corporate, branch-wide, or professional schemes
- The deal between the scheme and its participants
  - Non-profit foundation
  - Governance by employers and employees
  - Degree of solidarity (standard premium, no medical test)
- The deal between the government and the scheme
  - Government supervision
  - Tax concessions
  - Compulsory participation (usually)

Why compulsory participation?

- Employers
  - Relation between enterprises and workers
  - Economies of scale
  - No competition on pension conditions
- Employees
  - Continuity in case of mobility within the same sector
  - Better bankruptcy protection through independent schemes
- Pension scheme (benefits employers and employees)
  - Higher return on investments
  - Economies of scale and lower transaction costs

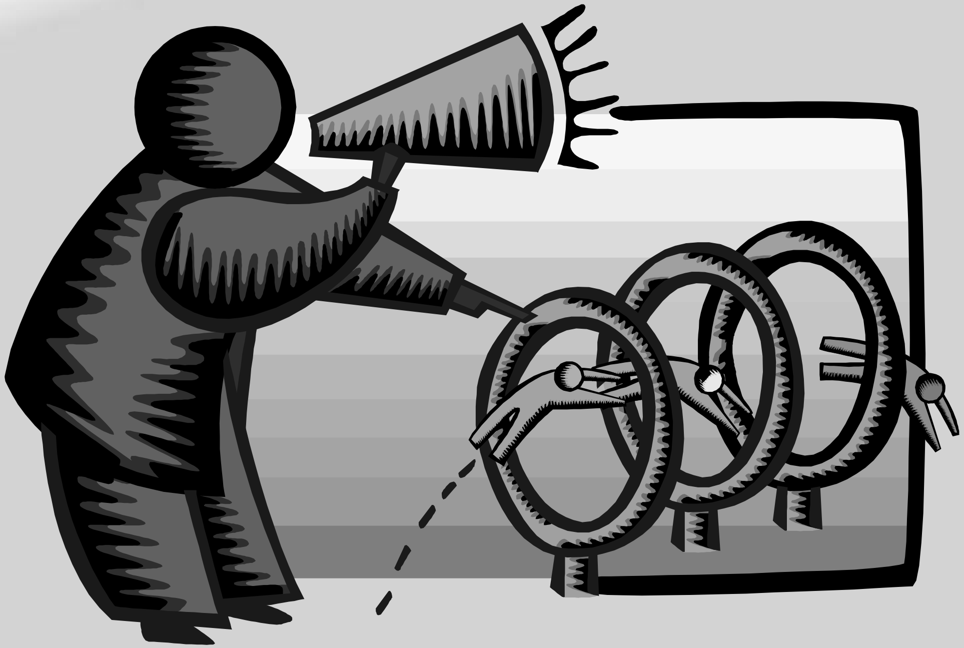
Second pillar threats

- Sensitive to investment results (but not investment cost)
- Financial heavyweights
- Requires expert financial supervision
- Social solidarity diminished

Second pillar opportunities

- Best “value for money”
- Many instruments for governance
  - Can take demographic developments into account
- Positive economic effects
  - Savings and growth
  - Financial markets (stocks, bonds, commodities)
  - Innovation and growth (private equity)
  - Corporate governance, social responsibility
- Diversification of systemic risk

Second pillar supervision choices



Authority doesn't work without prestige,
or prestige without distance.

Charles de Gaulle

The basic principle

- Quantitative restrictions
  - Financing government debt
  - Keep capital in
  - Serve other government objectives (e.g. housing)
  - Destroy pension value
  - Keep premiums unnecessarily high
- Prudent person principle (PPP)
  - Flexible and efficient
  - Need for expert supervisors

The *acquis communautaire*

- Principle of subsidiarity
- Regulation 1408/71 (coordination of social security)
- Directive 98/49/EC (pension rights and mobility)
- Directives on equal treatment of sexes (solidarity)
- Regulations on accounting standards and auditors
- IORP directive
- Jurisprudence
  - Barber: equal pension rights for men and women
  - Wielockx/Safir/Danner: equal tax treatment

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IORP investment rules (art. 18)

- Prudent person principle
  - No restrictions up to 70% equity
  - No restrictions up to 30% foreign currency
  - No restrictions for private equity
  - No third party loans
- Extra restrictions for cross-border funds
  - Maximum 30% in “unregulated markets”
  - Maximum 30% in foreign currency
  - Maximum 5% in sponsor, 10% in sponsoring concern

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And also…

- Art. 14: waiting for IAS
  - Cover ratio and sponsor
- Art. 15: cover ratio >100%
  - Discount rate: internal return or government bonds
- Art. 19: EU managers en custodians
  - Discrimination not allowed
- Art. 20: basis for EU-wide pension funds

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Way station

- Directive is a first step...
  - Develop prudent person principle
  - Liberalize restrictions
  - Point of departure for new members
- ...creating its own new problems
  - Supervision arbitrage
- EU-wide funds: Common Contractual Fund (CCF)
- Jurisprudence: AMS Management Systems vs. UK
- Review clause (art. 21)

What should be done

- Trustee requirements
- Common accountancy rules (IAS 19)
- Tax system harmonization
  - TEE (L, D (partly)) versus ETT (DK, S, IT) and EET (all others)
  - Agreement on EET?
- Pension transferability
  - Option: cross-border membership (fiscal treatment, supervision)
  - Option: stay with the fund (fiscal treatment)
  - Option: only within pillars (how to calculate differences in rights)

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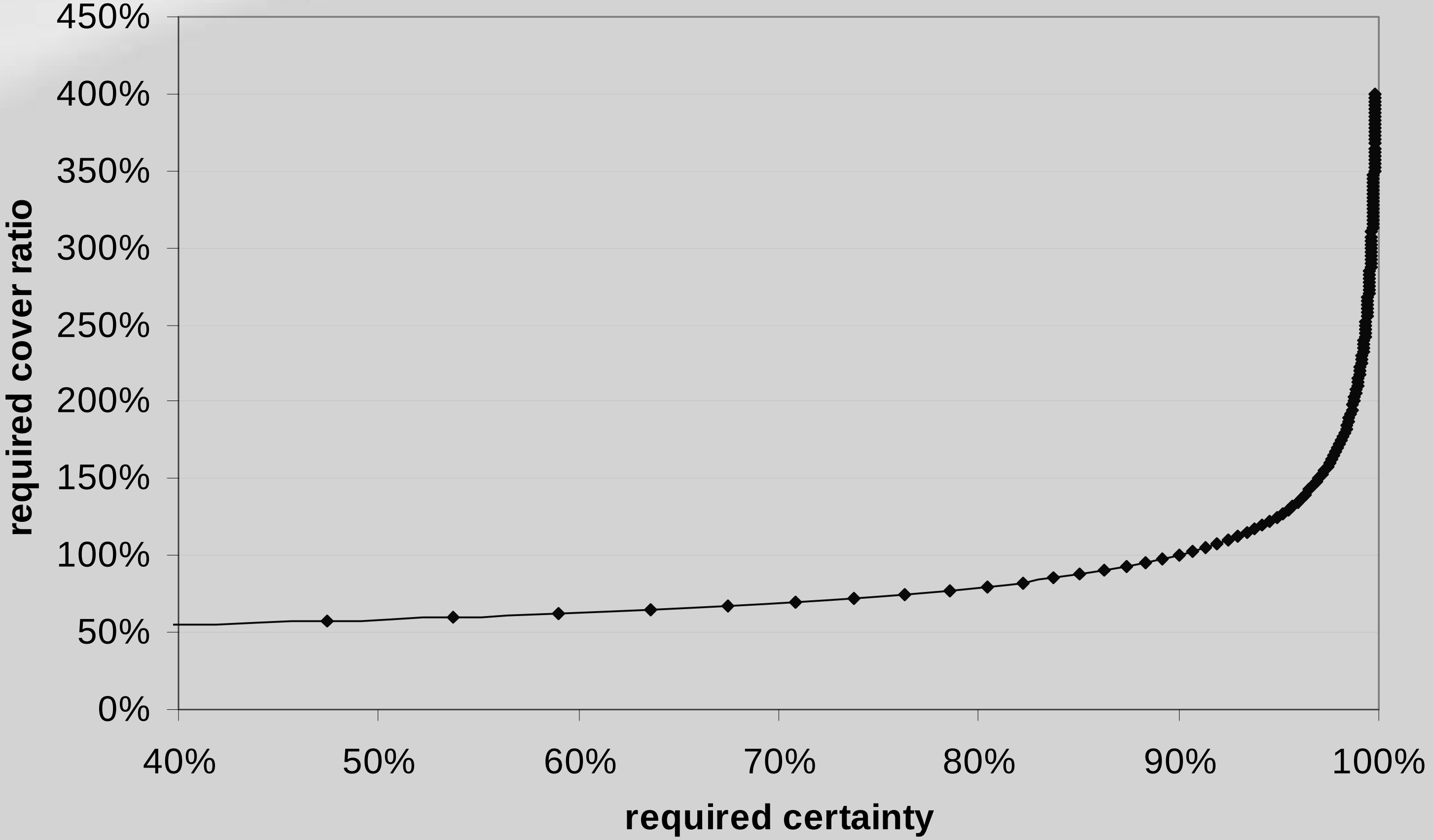
The supervision quandaries

- Mutual respect between supervisor and supervised
- Equilibrium between return and risk
- “Too lax” invites abuse
  - Bad investment decisions (Enron and the 5% rule)
  - Hollow or plundered funds (Robert Maxwell)
- “Too strict” costs money or quality
  - Demands cost, excessive demands destroy pension value
  - Example: the cost of certainty

The cost of certainty



PPP in practice, the Dutch case

- Solvability
  - Cover ratio: 105%
  - Reserve requirement: under discussion (110 – 145%)
- Certainty under discussion
- Liquidity and risk
  - Investment plan
  - Asset Liability Management
- Requirement of expertise of the Trustees
- Returns
  - Z-score and compulsory status

Division of supervisory labor

- Government – long term **certainty** and **price**
  - Supervision of PVK
  - Solvability (security)
  - Macro-economic consequences
- PVK – short term **certainty**
  - Liquidity
  - Global supervision of risk and return
- Pension funds – **price** and **quality**
  - Social partners' supervision of the organization

Current developments

- Merger of PVK and DNB ➔ risk supervision
- AFM ➔ supervision of behavior
- “White paper”: towards Financial Assessment Framework
  - Cover ratio: always 105% (was 100% at reporting time)
  - Buffers according to portfolio (new)
  - Certainty at 99,5% (political issue)
  - liabilities measured on fair value basis (“market rates”)
- Measured implementation of recovery plans
  - Further interpretations, leading to cover ratio at around 125%
  - Longer implementation time

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Pension fund instruments

- Premium, money coming in
  - Level and time period of payment
- ALM - money invested, determination of risk and return
- Pension deal (ambition level), money going out
  - Pension age
  - Inflation indexation
  - Final or average pay?
  - Defined benefits AND/or defined contribution?
  - Goodies (e.g. early retirement, partner pension, invalidity pension, premium at incapacitating sickness)

Criticism of the Dutch experience

- Premium holidays
- Equilibrium between return and risk
- Timing of extra reserve requirements
- Cover ratio and z-score
- Explanation of objectives and means
- Short term considerations: push towards DC
- Government: too much distance for the national interest

Suggestions

No army can withstand the strength
of an idea whose time has come

Victor Hugo

Words for the wise

- Learn from others what to avoid, not what to do
- Keep your eyes on your objectives, not history or politics
- Diversify systems to spread risk
- Place responsibility where it belongs
- Demand excellence from supervisors
- Demand quality from the supervised
- Legislate results, not behavior

In the long run, we are all retired!

Thank you for your attention