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Should we continue to close our eyes to the true cost of pensions?

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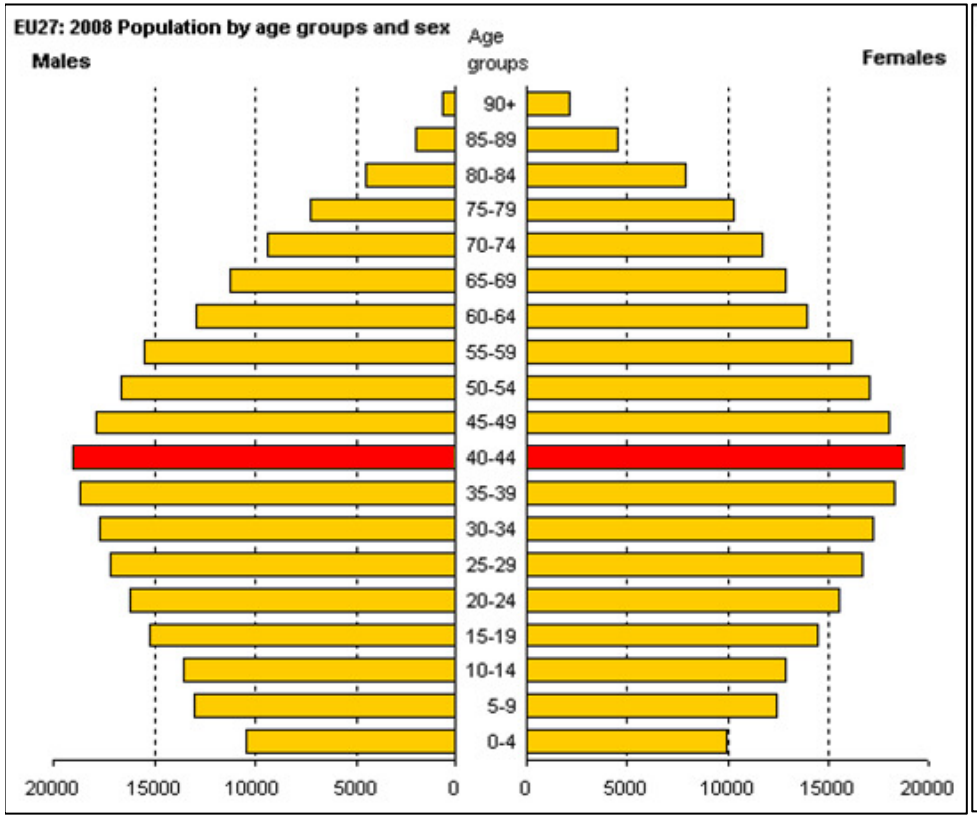
The good news

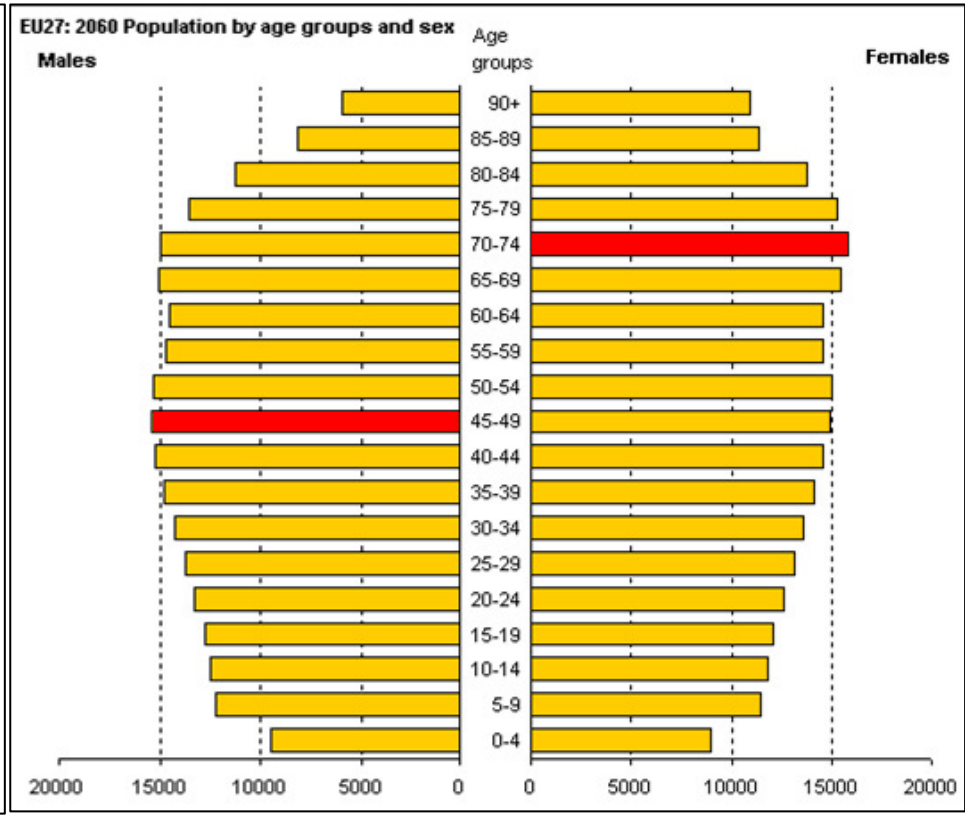
- We are in Athens, where democracy started
- We live longer
- Medical research will most likely make us live a more healthy life
- We are dreaming of a nice and comfortable pension
- We hope to retire soon at a reasonable age
- We have saved a lot of money for our old day
- Social security will save us

The bad news

- We are only here for a couple of days
- We do not know how long
- We might well be the victim of some mental disease
- We have no idea how big (or small) our entitlement will be
- We have no idea when that will be
- The money might be gone by the time we retire
- The state might be broke

Demographic structure of the EU population in 2008 and 2060

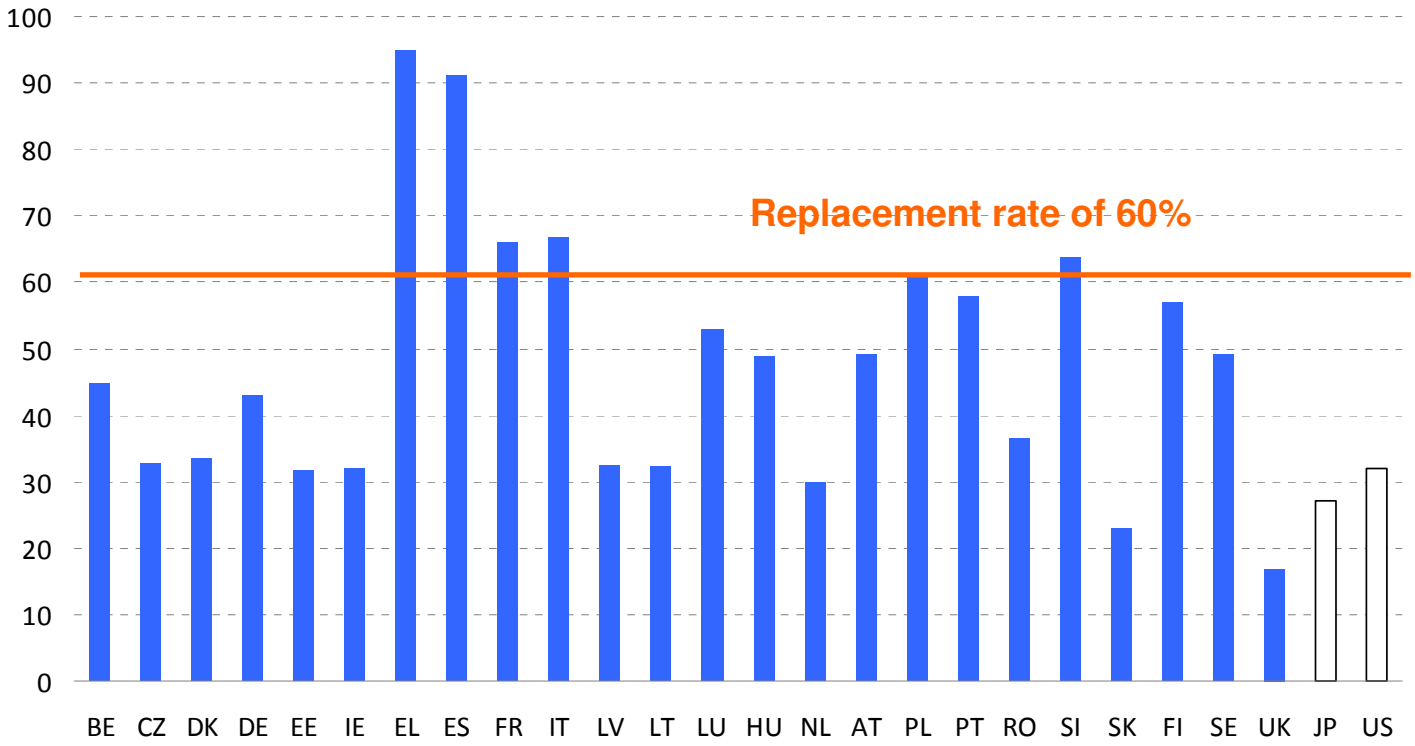




What are the options?

- Demographics are difficult to change although the situation in other parts of the world might look better than that in the EU
- For most countries in the world, the financing of retirement is a major challenge: adequacy and sustainability
- We must therefore develop creative solutions:
  - First pillar: raise retirement age and produce babies
  - Second pillar: enlist more people in pension funds
  - Third pillar: stimulate private investment and insurance
  - Fourth pillar: promote home ownership
  - Fifth pillar: the family circle as a solution

State pensions provide different levels of old-age income



Note: Gross replacement rate (% of last income) from state pension (source: European Commission and OECD.)

First pillar problems

- We can no longer rely on state pension as the only source of retirement income
- Pay as you go systems are unlikely to result in adequate pension because of longevity and the decreasing birth rate
- Prioritisation is necessary in order to channel funds to those people who really need support
- Postponement of retirement age will reduce the pressure on state budgets but resistence in population might be high
- Increase in birth rate or smart forms of immigration might bring some relief

Second pillar problems

- Not all employees are included in an occupational pension arrangement; mandatory enrollment can help
- Employers are closing defined benefit schemes, thereby pushing the risk back to private individuals
- Employees do not always have a choice in selecting their preferred investment strategy or are badly informed about their final entitlement
- Occupational pension funds do not always have good governance arrangements and costs might be high
- States become more and more greedy and are not afraid to expropriate pension fund money

Third pillar problems

- The financial crisis has brought us back to reality: there is nothing like a free lunch: markets can go up but they can also go down
- It is difficult for private persons to decide which investment vehicle is likely to be profitable in the end
- Many life insurance undertakings move away from long term guarantee products in favour of schemes that put the risk back to private individuals
- States are not afraid to take their share of the profits by various mechanisms of anticipative taxation (tax before the due date)

We do not want to know the truth

- Very few countries in the world have a clear picture about the impact of the pension cost for the state budget; as budgetary calculations are short term, there is a tendency to overlook the long term consequences
- Occupational pension funds and insurance undertakings rarely apply solvency rules that are reflecting the true cost of the pension liabilities
- Undertakings which carry the pension liabilities in their balance sheet tend to overestimate the return on investment and to apply a favourable discount rate to reduce the liabilities

Transparency as a solution

- Governments need to do their homework and confront the population with the real cost of state pensions in order to avoid an intergenerational conflict
- Undertakings need to indicate clearly whether and to what extent their is a pension gap in the calculation of the pension liabilities and how they intend to deal with this
- Pension funds should more clearly indicate what the likely pension entitlement is that members will receive
- Insurance undertakings and investment funds should communicate more clearly about investment choices and returns

Transparency requires discipline

- The party that takes on the risk should be required to calculate the liability in a manner that reflects all the risks on both the asset and the liability side
- Occupational pension funds might consider using a holistic balance sheet as a means to reduce the necessary capital buffer
- Counter-cyclical solutions:
  - Moving average of asset prices (equity dampener)
  - Extend the recovery period for solvency capital
  - Apply an appropriate discount rate for long term guarantee products rewarding matching

Truth and untruth in pension funds

- The EC's attempts to bring discipline into the way pension funds calculate their liabilities have been strongly criticised
- Unholy alliance between employers and trade-unions
- EC introduced a proposal on 27 March 2014 for a revision of the IORP Directive, which aims inter alia at improving the governance of pension funds and the transparency for pension scheme members and beneficiaries
- Is transparency really possible if we do not know how to calculate the pension liabilities?
- Are we not creating an unlevel playing field between pension funds and insurance undertakings?

Lessons from the past

- A problem does not go away by ignoring it
- Even with long term liabilities, there comes a time that payment is due
- Costs of managing pension schemes must be clearly stated
- Board members of pension funds must be fit and proper
- People are more ready to accept bad news if they have the feeling that something is being done about it
- Let us be honest, whether we are in defined benefit or defined contribution

Concluding remarks

- Adequacy is as much a problem as sustainability
- Health care and long term care must also be tackled
- People should receive at an early stage an overview of their likely pension entitlement (in each pillar)
- Information about investment returns and pension entitlement should follow the KISS principle (KID)
- Pension capital should be portable so as to maximize the return for employees changing jobs
- If longevity continues, we may want to change our life-cycle

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