"Pension funds should be clearly distinguished from insurance companies because their objective is to manage risks, rather than hedge them"

Guest Viewpoint: Anton van Nunen - Van Nunen & Partners

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Unless the rules governing pension funds are changed in the Netherlands, the Dutch system faces the dreadful prospect of nationalisation. A number of major external developments, mixed with regulatory weakness, are about to lower the axe on the Dutch system's roots.

First, pension provision is no longer seen as a fundamental part of corporate labour contracts. Labour contracts are becoming increasingly flexible, and the number of self-employed workers is rising. This causes an inherent development towards defined contribution (DC), as those trends are incompatible with inter-generational risk sharing. Investment risk and longevity risk are being gradually shifted to the individual members.

Second, the fundamental difference that exists between the young and the old has become more marked because of the ageing of the population. Younger people should invest for the long term and in riskier assets, whereas the elderly should focus on the short term and be risk-averse. A high discount factor, which is seen as desirable by pension funds, as it facilitates indexation, favours elderly members but essentially means less money is left for the younger members. At the same time, a low discount factor is detrimental to the elderly members, as it prevents indexation of pensions.

In the long term, however, a low discount rate is also detrimental for younger participants because it forces pension funds to lower the risk profile of their investments, which, in turn, lowers returns.

The gradual shift towards DC has also been fuelled by accounting standards, which encourage companies to cut ties with their pension funds.

More than two-thirds of future pensions depend on returns, so investment policy is extremely important, as is the discount factor. In 2007, in a mark-to-market frenzy, Dutch regulation changed the discount factor, replacing a fixed 4% with a risk-free swap rate.

That was wrong. Pension contracts are not marketable, so a market-based discount rate is not applicable. Pensions are not insurance policies; therefore a risk-free discount factor is inconsistent as well. According to Nobel Prize winners Miller and Modigliani, there is only one correct discount rate, and that is the expected rate of return of the pension fund's investment portfolio.

That is not meant to be carte blanche for using unrealistically high expected returns in order to pump up the funding ratio. The expected return should merely reflect the asset mix determined by the risk budget that the members see fit, together with reasonable expected returns per asset category.

In this setting, collective DC (CDC) would be the best alternative for the Dutch pension system. Within a CDC system, major risks could be spread between a large number of members. However, the current framework makes it very hard for pension funds to adapt to CDC.

We find ourselves in an odd situation, whereby pension funds' investments are largely determined by the funding ratio, while in fact it should be the other way around. The current regulatory environment dictates an extremely low discount factor for liabilities, driving down the actual funding ratio, reducing the available risk budget and, with that, curtailing pension investments in higher-yielding assets.

The regulator's aim seems to be to make pension contracts resemble insurance policies. This makes it almost impossible for pension funds to pursue their objectives. Pension funds should be clearly distinguished from insurance companies because their objective is to manage risks, rather than hedge them.

If pension funds were truly focused on managing risks, they would be able to take advantage of different risk premiums and the illiquidity premium.

Letting pension funds manage risk efficiently would make pension claims uncertain but, on average, investment returns would be significantly higher than those offered by insurers. Without a fixed discount rate, an average indexation of between 80% and 100% of future inflation would be realistically attainable. By defining the present value of liabilities using the currently abnormally low swap rates, this objective has become impossible. The essential difference between pensions and insurance policies ceases to exist.

This situation is having other indirect, and potentially very serious, consequences. First, is the amount of investment losses pension funds will experience when interest rates rise. Because pension funds in the Netherlands (and in some other countries) cannot find attractive returns under this ruling, they have been loading a time bomb onto their balance sheets, disguised as high-rated bonds. Second, investments and pension payments become highly pro-cyclical. In weak economic circumstances, pension payments are low, and premiums rise. Third, pension funds do not fulfil one of the macroeconomic functions of the pension industry, which is providing risk capital for companies.

The real reason behind such strict regulation is diverging objectives. The regulator wants to avoid financial failures and therefore sees strong balance sheets as the ultimate objective. Pension funds first want to build solid investment portfolios by taking and managing risks

and, second, to use their strong balance sheets to pay pensions. The ultimate objective for them is decent pension payments.

With pension funds forced to invest heavily in non-yielding bonds, the future looks bleak. Why should workers take part in a pension system that cannot promise decent payments, both in the short and the long run? Why waste premiums by investing in highly overpriced bonds instead of productive investments? In other words, the pension system is losing its attractiveness for members.

A possible answer is nationalising the pension system. This could be implemented in an evolutionary way: raising basic first-pillar old-age pensions, integrating that with a government-run second pillar and facilitating a people's private saving initiative.

The sad prospect of nationalisation has, nonetheless, two positive aspects. First, it would create larger entities in the pension world, which is the preference of the regulator, as they generally have better governance characteristics than smaller funds.

Then there is this pressure on Dutch pension funds to invest in start-ups and other risky activities in order to enhance anaemic growth. The idea behind this is that the huge amount of pension savings not only should serve as the reservoir for present and future pension income but also perform the important macroeconomic function of providing risk capital for entrepreneurs.

This pressure, coming from politicians in particular, is inconsistent with the tendency of risk reduction at pension funds due to grotesque discounting methods and the regulator's inclination towards hedging risks. Nationalisation would bridge this gap. It would create the size necessary for sufficient diversification when riskier assets are purchased.