The AMBACHTSHEER Letter

Sustainable Pension Design • Effective Pension Management

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TOWARDS 'INDIVIDUALIZED SOLIDARITY' IN PENSION DESIGN:

WHY THE DUTCH CAN AND SHOULD LEAD THE WAY

"Integrative thinking is the ability to hold two opposing ideas in mind at once, and then to reach a synthesis that contains elements of both but improves on each."

Roger Martin

Pension Turmoil in the Netherlands

The Dutch have been thought-leaders in the design and management of collective pension systems for a long time. Their 'collectivity' origins reach way back to the 'polder model', which reflects a special sort of Dutch solidarity forged by working together for centuries to keep the sea at bay. After the Dot.Com bubble more than a decade ago, pension regulator Dirk Witteveen declared in 2002 that, without major reforms, the Dutch pension system could end up under water too. Despite strong protests at the time, stronger funding rules were instituted, and it seemed that the system was healthy once again .... until the Global Financial Crisis struck in 2008/9.

The GFC raised even more fundamental questions about the 21st Century sustainability of the Dutch pension system (and for that matter, of every other pension system on earth too!). As a result of these questions in the Netherlands, the search for more sturdy models that could meet the '21st Century Sustainability' test was on. In our view, the Dutch have strong comparative advantages to be a global leader in pension innovation: high public interest level, strong pension expertise, strong pension institutions, and that centuries-old collective approach to problem solving.

As we write this, two new pension model candidates have surfaced over the course of the last few years, called 'the nominal contract' and 'the real contract' for short. Both models have their champions and detractors. But there is also a growing camp arguing that neither model scores well against such sustainability criteria as affordability, payment certainty, fairness, clarity of property rights, sensitivity to individual preferences, and pension contract understandability by plan participants. We are in the 'neither model' camp, and the brave goal of this *Letter* is to argue for an alternative by taking a number of apparently opposing ideas (e.g., enforcing solidarity vs. accommodating individual preferences at the same time) and to, in Roger Martin's words, "reach a synthesis that contains elements of both but improves on each".

Why 'Individualized Solidarity' is Not a Contradiction

In his book "*The Opposable Mind*" (Harvard Business School Press, 2007) Martin asserts people tend to address most challenging problems with 'either-or' mindsets .... when in fact 'and-and' solutions are often superior to forcing a decision between Choice A and B. In our view, so it is with 'individualization' and 'solidarity' in pension system design. The ideal pension design encompasses both elements. The challenge is to think through which elements of the system should accommodate individual preferences, and which elements are better addressed collectively.

A good 'individualize' example is investment risk. This kind of risk means very different things to the typical young worker ("how much can I afford to save now for decent retirement 40 years from now?") and the typical pensioner ("Will I get my pension next month without any reduction?"). These two questions graphically illustrate

that any pension formula that assumes uniform investment risk tolerance among all plan participants will leave everyone dissatisfied. The right application of 'solidarity' in this case is to offer plan participants separate long-horizon return-seeking, and shorter horizon payment-certainty investment tools, and to systematically transition exposure from the former to the latter over time.

A good 'collectivize' example is longevity risk within age cohorts. Within any group of same-age pensioners, for example, some will have short lives, and others long ones. But who will be in the short and the long ends of the mortality distribution is not known ahead of time. Pooling this uncertainty means annuities can be priced based on average life expectancy to the benefit of all. Another good 'collective' example is for large groups of pension plan participants to use the same pension management organization. Large organizations can manage investments and deliver pension administration with higher skill levels and greater economies of scale for the benefit of all.

Foundations for an 'Individualized Solidarity' Pension Model

So what does a pension model that scores high on such sustainability criteria as affordability, payment certainty, fairness, clarity of property rights, sensitivity to individual preferences, and pension contract understandability by plan participants look like? We start by drawing on the wisdom of the ages, personified by the genius of Albert Einstein (relativity theory), John Nash (game theory), Jan Tinbergen (public policy theory), John Maynard Keynes (public policy theory), Peter Drucker (governance theory), and TIAA-CREF (pension model design and implementation):

1. Albert Einstein once remarked: "Make things as simple as possible, but no simpler". In our view, most Dutch pension 'contracts' today cannot pass the Einstein test. They are too complicated for non-experts to understand. Worse, the current reform proposals create the risk these contracts will become even more complicated. This will reduce the already-declining public confidence and trust in the Dutch pension system even further.

2. John Nash warned: "Beware of bargaining arrangements that have potential 'win-lose' outcomes embedded in them … they will eventually become adversarial". Most Dutch pension arrangements today do not have clear property rights (e.g., the size and certainty of future balance sheet claims of younger and older plan members at any point in time are typically not fully defined). Nash's game theory model predicts that when adverse economic conditions such as 2008/9 arise, competing positions about the ownership of balance sheet assets and liabilities will arise. This has in fact come to pass. Looking ahead, the new 'real contract' proposes to perpetuate this 'win-lose' problem by using a discount rate curve based on three non-market-based, subjective parameters to determine how money is divided between younger and older plan beneficiaries.

3. Jan Tinbergen proved: "The number of economic goals to be attained must be matched by the number of instruments capable of achieving them". We noted above that two fundamental economic goals of pension systems are 1. Affordability, and 2. Payment-certainty. The Tinbergen rule states that achieving these two goals will require two financial instruments (i.e., a longer-term, wealth-creating instrument for affordability, and a shorter-term liability-hedging instrument for payment certainty). Let's call pension models that meet this dual test '2 goals -> 2 instruments' models.

4. John Maynard Keynes observed: "Institutional investors seem more interested in winning adversarial trading games ('beauty contests') amongst themselves than in creating long term wealth for their clients". Too many pension organizations continue to engage in zero-sum, adversarial, 'beauty contest' investment games, and too few are engaged in longer term wealth-creation strategies. The '2 goals -> 2 instruments' pension model offers a clear, unambiguous rationale for adopting explicit longer term wealth-creating investment programs. While such programs may be 'risky' in a short horizon context, they are much less so for multi-decade holding periods. At the same time, the payment-certainty instrument must give older workers and pensioners comfort that the deferred annuity contracts they have purchased will indeed pay the contracted amount.

5. Peter Drucker wrote: “Pension organizations need effective governance disciplines just as much as any other organization”. A growing body of research is confirming this reality. Only pension organizations with effective boards and managements can serve plan participants as well as they have a right to expect.
6. TIAA-CREF demonstrated: that large pension systems can successfully manage a ‘2 goals -> 2 instruments’ pension model for a very long time (e.g., since 1952). CREF permits participants to build a pension pot over long holding periods. TIAA permits participants to buy payment certainty through deferred annuities. A 2009 study showed that in the sample of 77,000 active plan participants, all age-cohorts were on track to replace at least 70% of their preretirement income (including the Social Security pension). See Hammond and Richardson, “*Staying on the Path to a Secure Retirement*”, TIAA-CREF Research Institute. Peter Drucker, a TIAA-CREF participant for many years, wrote approvingly about its ‘2 goals -> 2 instruments’ model in his 1976 book “*The Unseen Revolution*”.

Key Features of the ‘Individualized Solidarity’ Pension Model

All this translates into the reality that sustainable 21st Century pension arrangements have three key design features:

1. A Long Horizon Return-Seeking Investment Instrument: in the spirit of Keynes’ investment vision, such an investment program seeks, acquires, and nurtures sustainable, growing long horizon cash-flows in the form of dividends, rents, tolls from a diversified portfolio of public and private investment vehicles. The fact that ‘the market’ will value these cash-flows differently from day to day is irrelevant. Eventually (e.g., for 10-20 year+ holding periods), as long as the aggregate cash-flow of the long horizon portfolio performs as expected (e.g., grows in excess of the rate of inflation), ‘the market’ will value the portfolio on its economic merits. These programs are managed by engaged investors who, in the spirit of the Heisenberg Principle, positively impact investment outcomes through their individual and collective engagement strategies with investee organizations (e.g., public or private corporations). For more on this style of investing, see our September-December *Letters* last year, and the January-July *Letters* of this year.
2. A Liability-Driven Payment-Certainty Instrument: it supplies life-long payment certainty in the form of life annuities, which plan participants purchase at a ‘fair-value’ price (i.e., reflecting the actual structure of interest rates at the time of purchase and conservative longevity expectations). The balance sheet of this payment-certainty instrument is managed and regulated to ensure that payment promises made will be payment promises kept. In the spirit of Einstein’s ‘keep things as simple as possible’ dictum, there is only one simple (i.e., explainable), market-hedge-able form of annuity on offer. Members begin to purchase these annuities mid-career on a deferred basis and accumulate them gradually over a, say, 20-year period. There is nothing new in this, as current pension contracts are already designed to do this. What is new is that younger members no longer overpay, and older members no longer underpay for their deferred annuity purchases. Again, see prior *Letters* for more on this style of liability-driven investing.
3. A Life-Cycle Transition Protocol: it starts from the reality that people journey through three life phases: pre-work, work, and post-work. A target post-work standard of living is financed in part by a national pay-go old age pension component, and in part by worker savings and the investment return on those savings. Plan members receive regular updates of progress towards achieving the target pension on the target date. A default rule determines members’ allocations between the two investment instruments over the course of the work and post-work phases of their life-cycle (e.g., in the example above, the purchase of deferred annuities started mid-career and continues for a 20-year period). See last year’s August *Letter* for more on designing a functional life-cycle transition protocol. Also, see our policy paper “*The Canada Supplementary Pension*

Plan" (CD Howe Institute, 2008) on creating a collective pension arrangement for all Canadians without a work-place pension plan for even more detail. Some Dutch pension experts have been advocating the 'combi-contract', which has some of the key design features of the '2 goals -> 2 instruments' model, but still suffers from a lack of property rights clarity.

Of course, just agreeing to move to a '2 goals -> 2 instruments' pension arrangement doesn't get you there. It also requires a well-thought out, well-executed transition plan to get from here to there.

Getting from Here to There

Three steps must be agreed on to transition current collective Dutch pension arrangements to ones that meet the sustainability criteria of affordability, payment certainty, fairness, clarity of property rights, sensitivity to individual preferences, and pension 'contract' understandability by plan participants:

1. Create a protocol to convert current accrued collective pension rights of plan participants into '2 goals -> 2 instruments' pension rights: this protocol needs to pass the dual tests of understandability, and both actual and perceived fairness to all participants. Devising such a protocol will be hard, exacting work; but it only has to be done once.
2. Re-write pension laws to ensure '2 goals -> 2 instruments' models are legal: this will require legal expertise, common sense, and common 'greater good' purpose.
3. Engage pension plan participants in the process: the transition to '2 goals -> 2 instruments' pension models will not happen without broad public support. Gaining this support will require a radical communication strategy rethink. The Dutch media reporting of the pension reform debate thus far has been unhelpfully convoluted. As importantly, some of the pension experts involved in the reform debate appear to have been more interested in displaying their technical virtuosity than in using plain language understandable by the public at large.

A footnote to these three transition steps is the ongoing need to continue to raise the governance quality of Dutch pension organizations at the same time. Moving to the '2 goals -> 2 instruments' model does not impact organizational scale in any way. It does, however, help clarify the specialist skill sets needed for organizational success.

Why Should the Dutch Lead?

Through his 2002 declaration, Dirk Witteveen (deceased in 2007) was the first public official anywhere in the world to sound the alarm that the global pension environment had changed, and that pension arrangements would have to adapt to it. Since then, these adaptation processes everywhere have been unfolding painfully slowly. Through their culture and their expertise, the Dutch have strong comparative advantages to be the first country in the world to successfully adapt their pension system to the longer term global realities of aging populations, rising longevity, slower economic growth, and lower investment returns. A new Dirk Witteveen must step forward.

One final point. Some argue that the Dutch pension reform window is closing, and that it is better to implement the proposed (but flawed) 'nominal' and 'real' contracts now, rather than spend more time finalizing a contract that can truly pass the sustainability tests of affordability, payment certainty, fairness, clarity of property rights, sensitivity to individual preferences, and pension contract understandability by plan participants. We favour the opposite argument. It is far better to spend a little more time getting the contract right now, than spending much more time later cleaning up an even bigger pension mess. Or, to quote a Dutch friend: "Beter ten halve gekeerd, dan ten hele gedwaald!"

CARPE DIEM!

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