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Letter from Minister Donner about recovery plans

On Friday 20 February 2009, Minister Donner announced in a letter to the Lower House of the Dutch Parliament that the period for repairing funding shortfalls would be extended across the board to five years. The Minister is therefore acceding to the request from the pension sector for a relaxation of the recovery requirements in view of the exceptional circumstances.

The same exceptional circumstances and the distortions on the interbank swap market had already caused the Dutch Central Bank (DNB) to allow a so-called 'frozen' interest rate to be applied from year 5 onwards in the long-term recovery plan. As a result, the fund's liabilities after 15 years will be approximately 15% lower than in a situation where interest rates develop from one year to the next.

In return for the extension of the recovery period, funds must indicate, when submitting their recovery plan, how they will act if the recovery falls short of expectations. If this happens, the proposed measures will have to be implemented a year later.

It still remains the case that all funds facing a shortfall situation must submit their recovery plans to DNB by 1 April 2009. DNB will assess these plans over the subsequent three months. A deterministic funding ratio template must be at the heart of the plans. Furthermore, a recovery plan must contain an explanation in words, a statement of the risk exposure, an asset overview, an explanation in figures of the origin of the shortfall and a continuity analysis.

The principal justification for the concessions, in the opinion of Watson Wyatt, is the fact that the markets do not yet seem to have stabilised. As long as this has not happened, any major decision may in retrospect turn out to be rash. Conversely, however, major decisions should not be postponed unnecessarily either. Cases of prolonged underfunding pose a threat to the pension system. If the cost of membership of a pension fund is expected to exceed the benefit, stakeholders may want to terminate their membership. In itself, the deferral of painful decisions may damage confidence in the pension system.

Effects of interest rates at year-end 2008

The financial developments during 2008 have had different implications for pension funds (using the Financial Assessment Framework, or FTK) and companies (using IFRS). Apart from differences in the rules and parameters to be applied, this is also due to the different objectives of the two types of reporting.

The FTK is aimed primarily at the entitlements already accrued in a pension fund. These entitlements are valued based on an interest rate that can be regarded as virtually risk-free because the entitlements themselves would have to be regarded as virtually risk-free. In the Netherlands, the swap market has been chosen as the basis. IFRS also takes account of future accrual, in which case the continuity of the company is a co-determining factor. Therefore, the calculation is based on an interest rate that has to reflect that risk, rather than on a risk-free interest rate. The general standard for that interest rate, as laid down in the reporting guidelines, is an interest rate that includes a mark-up to take account of the creditworthiness of high-quality companies. These mark-ups have greatly increased over the past 18 months, and as a result the difference between the two interest rates described is now much larger. It is also the case that the change in the interest rate (the so-called discount rate) for IFRS for the whole of 2008 is around zero, since the decline in the risk-free interest rate kept pace with the increase in the credit mark-ups.

The difference in the interest rates used therefore results in a large difference between the value of the liabilities determined in accordance with one method compared to the value based on the other method. However, there are also other differences between the two valuation methods. One of these differences concerns the valuation of future indexation grants. These grants are disregarded under the FTK, but not under IFRS. The value is based on the expected future indexation. Because of the current circumstances, this expectation has been lowered. It is therefore not the interest rate (which has generally remained more or less the same) but the lower expected indexation that has reduced the value of the total liabilities according to IFRS. This is an economic reality.

The media have rightly concluded that the credit crunch has had a greater effect on valuation under the FTK than on valuation under IFRS. In our view, however, the conclusions drawn by some must be put into perspective (see, for example, the article entitled *Boekhoudregels verhullen effect van de kredietcrisis* ('Accounting rules disguise effect of the credit crunch') in the *Financieele Dagblad* of 8 January 2009). In addition to that article's conclusion that interest rate rises will cause liabilities to decrease by around 40% being a gross overestimation when compared with our own observations, that decrease is also largely based on economic reality, i.e. the lower expected indexation.

Indexation clause to be submitted to the AFM?

Where conditional indexation schemes are concerned, the use of prescribed texts in the pension regulations, introductory letter and other communications is obligatory from 1 January 2009. These texts are set out in the indexations matrix attached as an annex to the amendment of the Pensions Act Regulation (*Regeling Pensioenwet*) which was published on 9 July 2008. It is possible to deviate from the prescribed texts from the indexations matrix in consultation with the Netherlands Authority for the Financial Markets (AFM). Many questions about real situations have been raised regarding this new role for the AFM. In response, the AFM has published a document on its website to clarify the arrangements.

The document reveals first of all that an alternative text can only be used after it has been discussed with the AFM. The AFM will only agree to a different text if the text in the indexations matrix is demonstrably incorrect or incomprehensible, or if the alternative text is clearer than the prescribed text. A different text must in any case contain the same substantive information and be equally brief and to the point. The different text must be submitted in writing to the AFM – preferably by e-mail – stating the deviation and the reason for the deviation.

In addition to the general criteria for using alternative texts, the document also addresses the most frequently asked questions about the indexations matrix and the indexations label. Various aspects are explained in more detail. The document also reveals that a number of points have already been identified as incorrect or incomprehensible. The document indicates how the prescribed texts can be amended in respect of these points. There will be no need subsequently to submit these adjustments to the AFM. One of the questions concerns the addition of text to the prescribed texts. The AFM states that the addition of text by way of explanation, supplementation and/or clarification is permitted without prior consultation with the AFM. However, this is subject to the condition that the additional text must increase the clarity, comprehensibility and correctness of the information on the indexations policy. The responsibility in this regard lies with the pension administrator. The AFM reserves the right to assess the added texts retrospectively.

In our experience, most of the indexation clauses used in practice are not an exact copy of the prescribed texts in the indexations matrix. The boundary between 'deviating text' and 'additional text' cannot be defined in general terms. Where the boundary lies differs from one indexation clause to another. We recommend that you check your indexation clause against the criteria which the AFM has announced that it will apply. Depending on the outcome of this check, you can then decide whether to submit the text of the indexation clause to the AFM just to be on the safe side.

Poor investment return and imminent retirement

Because of the current economic circumstances, employees with a defined-contribution agreement who are retiring now or will do so in the near future can only buy a relatively low pension. Owing to the poor investment

return, the pension capital available on the retirement date is lower than originally expected. In addition, the pension benefits are further reduced by the low interest rates. These lower pension benefits cannot be restored any more by future (favourable) investment returns because the Pensions Act defines a retirement pension as "the payment of fixed monetary benefits to the (former) employee".

In the November 2008 issue of Update we argued that the reintroduction of the split-annuity concept might offer some relief because, under tax laws and regulations it was and still is permitted to use part of the capital for temporary benefits and to carry forward the remaining capital in the hope that stock exchange prices will recover and interest rates will rise.

On 12 November 2008, MP Stef Blok (VVD) asked the Government whether it was prepared to reinstate the split-annuity concept. The Minister of Social Affairs and Employment, speaking also on behalf of the State Secretary of Finance, responded in the affirmative on 5 February 2009. In his reply, he indicated that it was desirable to create a temporary split-annuity facility. In this context, 'temporary' means that persons who retire before 1 January 2014 at the latest will be able on the retirement date to postpone the purchase of part of their pension by a maximum of five years.

Further information

If you would like further information about the matters addressed in this issue of the Watson Wyatt Update, please contact Wichert Hoekert (Letter from Minister Donner about recovery plans), Gerhard Veluwenkamp (Effects of interest rates at year-end 2008), Jeroen Röder (Indexation clause to be submitted to the AFM?) or Jetty Lahoye (Poor investment return and imminent retirement).