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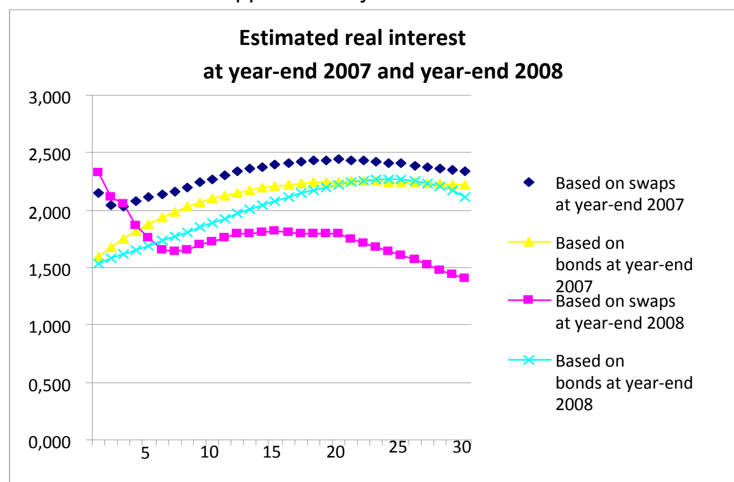
Real interest rates at year-end 2008

The majority of pension funds have either cancelled indexation in the short term or its future is uncertain. Nevertheless, this year Watson Wyatt is once again reporting the real coverage ratio in its actuarial annual documents. In our opinion, this information has not lost any of its importance given the pension funds' objective of providing old age pension that is resistant to fluctuations in purchasing power.

Since the beginning of 2008 Watson Wyatt has published a monthly estimate of real interest rates on its website. This interest rate is based on the returns from 'inflation-linked government bonds'. As of January 2009, this monthly publication will include a second interest rate structure, namely the interest rate structure for the real interest rate based on inflation swaps. There are sound arguments in favour of using both interest rate structures. The swap curve has the advantages of consistency with the interest rate structure for nominal interest as published by DNB (also based on swaps) and of the liquidity of the market in inflation swaps, which is much greater than for inflation-linked government bonds. Government bonds' great advantage is that they are based on the safest possible security, namely that of the issuing state. Moreover, the pure structure means they are extremely suitable for theoretical analysis.

In this year's actuarial reports the interest rate based on inflation swaps will be the starting point. The most important reason for choosing this starting point is the considerable credit spread in the curve based on government bonds: most of these bonds are issued by the French government which the market regards as substantially less creditworthy than, for example, the German government. When using the curve based on government bonds, one could consider applying a mark-down on the interest rates accordingly.

As regards the technical provisions of a standard pension fund, the real interest as of 31 December 2008 on the basis of inflation swaps corresponds to a constant interest rate of approximately 1.9%. The real interest on the basis of government bonds corresponds to a constant interest rate of approximately 1.3%. The graph below shows the two curves and the curves at the end of 2007. The graph also shows that the spread at the time was the other way around and stood at approximately 0.2%.



Instructions about submitting recovery plans

On Monday 19 January 2009, DNB gave a detailed explanation of the letter that was sent to pension fund boards on 18 December 2008 at a meeting organised for fund boards. The instructions relate to the submission of recovery plans and therefore apply to all funds which currently have an insufficient coverage ratio or a shortfall in reserves.

The recovery plans have to be substantiated in what is referred to as a 'coverage ratio template' which shows the expected development of the coverage ratio based on a set standard formula. Besides this deterministic scenario, a continuity analysis also has to be submitted. Other requirements regarding submission (which should be as standard as possible) can be found on the DNB website.

The most notable requirements relate to the premium and the interest rate structure that is to be used. The letter states that the premium has to contribute to the recovery. In the explanation provided on 19 January, DNB stated that this means that the premium coverage ratio has to be greater than 105% during a coverage shortfall. For the interest rate structure to be applied in the recovery plans DNB uses the space allowed by the Parameters Scheme (*Regeling Parameters*) to give permission to freeze the curve from the point in time when t=5. In view of the downward trend in the interest rate structures from that point in time, freezing the curve has a positive effect on the level of the technical provisions. In this regard, Watson Wyatt is of the opinion that the development of the assumption for returns on fixed-interest securities must have a logical relationship with the assumed development of the interest.

The recovery plans have to be based on the situation as at 31 December 2008. The plans have to be submitted before 1 April 2009. DNB will then assess the plans before 1 July 2009.

'Additional payments problem' in the case of value transfers

In a letter dated 8 January 2009, STAR (the labour foundation) and the pension umbrella organisations concluded that the 'additional payments problem' in the case of individual value transfers will be difficult to solve in the short term. The problem relates to the high additional payments made by mostly small employers with a directly insured pension scheme if there is an incoming value transfer. Two causes have been identified. The first cause is that there is a difference between the interest rate used by insurers to finance directly insured pension schemes and the statutory interest rate for value transfers. The second cause is that, in the case of value transfers, the value of the accrued (nominal) pension entitlements of employees changing jobs must not be changed.

STAR concludes that, if the current system is maintained, it will still be possible to reduce the additional payments where applicable. The payments can be reduced, for example, by adding a fixed 20% mark-up to the transfer value, except when the coverage ratio of one or both of the pension funds involved is lower than 120%. In that situation the mark-up is made equal in percentage terms to the lowest coverage ratio minus 100. However, now that the credit crunch has resulted in the coverage ratios of many pension funds dropping below the required level of own assets, this solution will scarcely reduce high additional payments. STAR therefore proposes that a reticent attitude be adopted for 2009, including as regards modifying regulations. STAR is prepared to re-examine the variant with the fixed mark-up in a year's time.

Taxation on Excessive Remuneration Components Act (*Wet belastingheffing excessieve beloningsbestanddelen*)

In the July/August 2008 Update we informed you about the Taxation on Excessive Remuneration Components Act. The bill was passed in the Upper House on 9 December 2008 and the Act came into effect on 1 January 2009.

The Taxation on Excessive Remuneration Components Act introduced three fiscal measures aimed at preventing pay policy excesses. We will not examine one of these measures (taxation on what is referred to as ‘carried interest’) because it does not include a specific pension or ending of employment element.

The other two measures are:

1. Employer levy in the event of excessive severance pay:
If severance pay is given to an employee who receives an annual salary of more than € 500,000 (assessed income), the employer will owe a levy of 30% on the severance pay in so far as that levy is higher than the annual salary. If, under the original Article 32aa (now Article 32ba) of the Wages and Salaries Tax Act 1964 (*Wet op de loonbelasting 1964*), a levy is already owed in relation to an early retirement scheme, the levy relating to the severance pay will not be applied. No accumulation will therefore take place. The employer's levy on excessive severance pay relates to employment relationships that ended on or after 1 January 2009.

2. Employer's levy in the event of back service:
In the case of a pensionable salary of more than € 500,000, the employer, in the event of an increase in the pensionable salary, will owe a 15% levy on a fixed back service allocated to this increase. We should add, even though it may be stating the obvious, that the measure only applies to final salary schemes. The Wages and Salaries Tax Act 1964 is to be changed in respect of this point as of 1 January 2010. As we indicated earlier, this provides space for any negotiations on the terms and conditions of employment and any adaptation of the pension scheme.

Compliance with rules for pension scheme reporting could be better

In a report on supervision of the financial reporting of listed companies, which was published at the end of 2008, the AFM states that the reporting on a number of aspects could be improved. One of the points refers to the reporting on pension schemes on the basis of IAS 19.

In 2008, compliance with the reporting requirements for pensions was the subject of specific research. The AFM states, on the basis of that research, that the explanatory notes to pensions in the annual accounts have been improved in comparison to previous years. Nevertheless, there is still room for further improvement. For example, it appears that the majority of companies do not comply with the requirements relating to historical information about gross and net obligations and capital base. There is also no historical overview of the profits and losses due to changes in assumptions. Moreover, almost a quarter of companies provide a description of the pension scheme which is too general.

The company is responsible for reporting in general and therefore also for reporting about pensions. Watson Wyatt can supply the necessary information and in the specific case of IAS 19 it can give recommendations about the requirements and the advisable issues as regards the annual accounts.

More information

If you would like further information about the matters addressed in this issue of the Watson Wyatt Update, please contact Wichert Hoekert (Real interest rates at year-end 2008, Instructions about submitting recovery plans and Compliance with the rules for pension scheme reporting could be better), Mirella Verhaaf ('Additional payments problem in the case of value transfers) or Jetty Lahoye (‘Taxation on Excessive Remuneration Components Act’).