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### Effects of the credit crisis on discount rates

One of the many consequences of the credit crisis is that the credit spreads of corporate bonds have increased sharply over the past months. The table below presents this trend, showing the credit spread for the principal category for international reporting standards (i.e. AA-category corporate bonds with remaining terms exceeding ten years). According to these standards, the discount rate is to be based on 'high-quality bonds'. This requirement is generally interpreted as involving AA corporate bonds. A greater credit spread means a higher discount rate and, consequently, a drop in the value of pension obligations. Since 2006, Watson Wyatt has based its calculations of credit spreads on the information provided by iBoxx. iBoxx compiles information from various rating agencies (i.e. Fitch, Moody's and Standard & Poor's). Until the end of December 2007, iBoxx applied the lowest of the ratings awarded. In January 2008, this was changed to the average of the ratings awarded, resulting in a slight increase in the credit spread. However, most of the increase can be attributed to the uncertainty on the financial markets. Although it is possible to question whether a bond with a credit spread of 2%, for example, can still be termed high quality, there are as yet – considering the unaltered AA rating of the bonds – no grounds to assume otherwise.

We make one exception to that rule in the credit spreads as at the end of February and the end of March 2008. On those dates, the 'exceeding ten years' category, consisting of 14 bonds, included a Barclays bond that is qualified as a preference share. As at 31 March, that bond had an individual credit spread of more than 6%. Due to the substantial deviation from all other bonds, we removed that bond. As a result, the credit spread for the 'AA Corporates 10+' group decreased by slightly more than 35 base points.

In Watson Wyatt's opinion, the increased credit spread may distort the actual value of pension obligations. Nevertheless, in our view it is advisable to continue to use the method adopted, in particular for reasons of consistency, unless specific circumstances dictate another approach. We advise our clients to discuss these developments with their accountants.

Date	AA Corporates 10+ credit spread according to iBoxx
31/12/2006	0.53%
31/3/2007	0.54%
30/6/2007	0.59%
30/9/2007	0.75%
31/12/2007	0.95%
31/1/2008	1.28%
29/2/2008	1.08% (including the Barclays bond: 1.33%)
31/3/2008	1.48% (including the Barclays bond: 1.85%)

### Ervaringssterfte

The survival rates in the Dutch Actuarial Association's forecast table are based on mortality rates for the Dutch population as a whole. Experience shows, however, that the working population is healthier and as such lives longer than the Dutch population as a whole. Moreover, the longevity of participants with higher pension claims (i.e. higher income brackets) also exceeds the average. In order to adjust the mortality rates in the Actuarial Association's forecast table to reflect these effects, we use mortality experience (i.e. age-linked mortality rate adjustment). At the start of this year, we updated our mortality research. The results of that study were used to generate a new adjustment table to get to the working population mortality – Watson Wyatt's Ervaringssterfte 2008.

Watson Wyatt's Ervaringssterfte 2008 is based on mortality rates for 2005 en 2006 of twelve major Dutch pension funds. In all, 6.5 million participants were included in the study, which revealed that total population did not experience any major shifts away from the mortality experience that we used previously. However, for individual pension funds, Watson Wyatt's Ervaringssterfte 2008 may result in adjustments to their provisions. This depends primarily on the composition of the pension fund's member base (i.e. age and gender).

From now on, we will compile mortality rates annually in order to ensure that the mortality experience remains as up-to-date as possible and to adjust it where necessary.

### Developments on the financial markets: implications for pension funds

On 28 March 2008, the Dutch Central Bank (DNB) issued a letter warning about negative developments on the equity market and lower interest rates, which resulted in drops in the coverage ratios of a large majority of pension funds. The letter set out information about the implications of the current situation on the financial markets and the

legal obligations of pension funds in connection with those implications.

To ensure that pension funds can actually meet their pension commitments, the system of the Financial Assessment Framework (*Financieel Toestingskader*, FTK) was incorporated into the Dutch Pensions Act (*Pensioenwet*). The FTK's significance lies primarily in that it requires properly substantiated policies for contributions, supplementary allowances and investments, with a view to the long term and at a coverage ratio sufficiently strong to withstand unfavourable developments. The FTK encourages pension funds to build up extra reserves (buffers) in prosperous times and demands that those buffers be restored if they no longer meet the minimum requirements. If a pension fund can foresee or may reasonably be expected to be able to foresee that it will no longer meet the relevant standards for equity, it is obliged to notify DNB of that fact without delay. Reports from pension funds about their coverage ratios at year-end 2007 and the market developments since then indicate that a number of pension funds may have deficits in their reserves. DNB has announced that it has received several reports of such deficits. The pension funds in question are required to submit long-term recovery plans within three months. If their Actuarial and Technical Business Memorandum (*Actuariële Bedrijfstechische Nota*, ABTN) specifies a policy in this connection, the recovery plan need only refer to that policy.

Pension funds that fall short of the minimum standards for equity have a coverage deficit and are required to submit a short-term recovery plan to DNB within two months. Pursuant to the statutory obligations referred to above, pension funds must possess current information about their coverage ratios and their boards must adopt a more active approach as the fund nears the danger zone. These rules are designed to ensure that pension funds remain in compliance with the requirements set out in the FTK.

### **VNO-NCW's pension memorandum**

In March, employers' organisation VNO-NCW published a memorandum about the Dutch pension system and its future. VNO-NCW argues that, although people greatly appreciate the system's positive aspects (i.e. its cohesion and its collective and obligatory character), some changes are nevertheless necessary in order to preserve those positive aspects. The organisation believes first of all that risks should be minimised and divided differently. Moreover, a more emphatic consideration is required of methods for quickly raising the effective retirement age (currently around 60.5).

The principal reason for the desire to change the system is that pensions are becoming too expensive and the related risks too great. In the employers' view, this is due in part to recent legislative amendments, such as the near total prohibition on contribution discounts and the excessive information requirements. If Solvency II takes on the same form for pension funds as the standard for insurers, the costs will only continue to increase.

To minimise risks, VNO-NCW argues, as discussed extensively in the daily newspaper *Het Financieele Dagblad* and elsewhere that policies for supplementary

allowances should not be incorporated into pension regulations, rather supplementary allowances should be determined by the social partners on a case-by-case basis. This will eliminate the suggestion that automatic supplementary allowances are the standard, while at the same time ensuring that it will be impossible for employees to claim entitlement to supplementary allowances in the future, based on commitments that were intended to be conditional. Against this background, it should also be considered that VNO-NCW, together with the Dutch Association of Company Pension Funds and the VVD political party, has questioned the introduction of the indexation label, although based on their belief that it contributes little in terms of understandability.

By reallocating risks, VNO-NCW refers primarily to shifting risks from the employer to the employee. One option for achieving this is a 'collective defined contribution scheme'. VNO-NCW's memorandum asks that the legislature grant this pension form legal status as quickly as possible. Other suggestions include The Optimal Pension System (TOPS) advocated by Keith Ambachtsheer of Canada and the 'flexible defined benefit scheme', as part of which the retirement age is linked to life expectancy. Another suggestion is to have employees pay a larger share of the contributions.

In response to an aging population, VNO-NCW feels that it is high time to consider ways to raise the effective retirement age. In addition to creative solutions involving part-time retirement and demotion and tax incentives to make it more attractive for employees to continue working until they reach retirement age, another important solution may be to gradually raise the statutory retirement age, possibly linked to an increase in life expectancy.

As the final option for reducing the costs of pensions, VNO-NCW considers diminishing the second pillar in favour of the third pillar. This would ensure that the target remains 70% of the employee's salary, though a greater share will originate from the third pillar.

Watson Wyatt shares VNO-NCW's concern about the tenability of the pension system, yet more than that, Watson Wyatt shares the ambition to put forward every effort to preserve the system's unique qualities. Ideally, supplementary allowances will play an important part. Their conditional character was an important development toward better dividing the risks, and it is important to continually consider alternative ways to share and reallocate risks, both between employer and employee and between separate groups of employees.

#### **More information**

For further information about the matters discussed in this issue of *Watson Wyatt Update*, please contact Wichert Hoekert (Effects of the credit crisis on discount rates and VNO-NCW's pension memorandum), Peter Klaren (Ervaringssterfte) or Pauline Bakker (Developments on the financial markets: implications for pension funds).