Speech Brussels Economic Forum – Dick Sluimers

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Ladies and Gentlemen,

It is a great honour for me – as a representative of the private sector – to discuss the Ageing 2009 report here today at this conference, which – I must say – is dominated by representatives of the public sector. Fortunately, my company – APG All Pensions Group – is among others also the sole provider of the pension fund of the Dutch public sector. So, the link with the public sector still exists. But I believe that it is very important to involve the private sector as well. As I will explain today, the contribution of the private sector will be essential in solving the problem of ageing.

The Ageing 2009 report makes clear that there is still a lot of work to do in the EU in order to make our Union ageing proof. As a result of unprecedented demographic trends, the old-age dependency ratio - the number of elderly people as a percentage of the potential labour force - is projected to more than double in the EU, from 25% to 54%. Of course, this will have a profound impact on societies as a whole. But because of my background as a pension provider, I will restrict myself to the issue of pensions. My main message, today, is that a further development of funded pension systems – preferably collective funded pension systems – is essential to supplement future generations with an adequate and sustainable retirement income.

In the Ageing 2009 report, there are considerable differences in the projected effects of ageing on public pension expenditures in the different European countries. In some member states, pension expenditures will increase by more than 10% of GDP, while in other countries the costs as a percentage of GDP will even slightly decrease. These differences can be explained by the degree in which governments have reformed public pay-as-you-go schemes. But the effects of ageing also depend to a large extent on the way pension systems are organized in the different member states.

Although the principle of saving for old age is relatively straightforward, over the course of time European countries have developed a host of different pension systems. Traditionally, pension systems are described by distinguishing three types, “pillars”, of pension income: the first pillar entails state pensions, mostly on a pay-as-you-go basis; the second pillar comprises funded occupational pensions; and the third pillar constitutes individual pension products and savings. This is also called the “classical trichotomy”.

Most economists advocate a proper balance between the three pension pillars in order to achieve an optimal diversification of risks. First pillar pensions are very vulnerable in the wake of demographic

shocks. Second and third pillar pension are very sensitive to interest rate and inflation risk. For example, in the Netherlands we have a pension system, in which these risks are well-diversified. On average 45% of the pension income of a retiree is dependent on the first pillar, 45% of the second pillar and 10% of the third pillar. In a lot of other European countries –especially in South Europe - the pension income is almost completely dependent of the first pillar. Member states with a substantial funded pillar – like the Netherlands - will face a more modest increase in public pension expenditures and are less susceptible to ageing.

An additional advantage of funded pension systems is that they moderate the budgetary effects of ageing by increasing future tax revenues. In most countries, pension contributions are tax deductible, the returns on these contributions are exempt from taxation and the benefits are taxed. So, member states with funded pension pillars will benefit from a rise in income from taxation in the next decades due to ageing. In the Netherlands, for example, the increase in tax revenues is expected to exactly offset the increase in public pay-as-you-go pensions. In this way the Dutch pension system will finance the costs of ageing by itself. Of course, this beneficial effect of funded pensions is not taken into account in the 2009 Ageing Report, which focuses exclusively on the expenditure side of the government budget.

Nowadays, in many European countries pension provision is still largely dependent on public pay-as-you-go schemes. As a consequence, some of these member states will experience a sharp rise in pension expenditures, which jeopardizes the sustainability of public finances. In other member states, governments have already implemented substantial reforms of public pension provision, which puts the adequacy of future retirement income under pressure. But it also may threaten sustainability as future retirees may demand higher pension benefits through the ballot box. In both cases, a shift towards funded pensions is essential to keep government budgets on a sustainable path.

The 2009 Ageing Report does not incorporate the detrimental effects of the financial crisis on public finances. The economic contraction has already resulted in large upward revisions of government deficits. The billions of euros of state funds to bail out banks and insurers have increased public debt. As a consequence, I fear that the crisis will exert additional pressure on public pension provision. So, in my opinion, now more than ever, the further development of private funded pension systems is essential.

Ladies and gentlemen, in order to keep the government expenditures sustainable, some European countries already decided to reform their pension system and introduced partially or completely funded pension schemes in the last decade. Most of the new funded pension systems – especially in Central and Eastern Europe – were based on an individual design, where every individual has his own personal pension account. I believe the World Bank of Mr Holzmann is a strong proponent of such mandatory individual pension pillars.

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In such defined contribution schemes a fixed contribution is made to the individual account of the employee. The pension income upon retirement fully depends on the returns on the investment portfolio. As a consequence, individual participants in these personal accounts were directly exposed to the fall in asset prices and, hence, lost a substantial part of their retirement savings. So, for these people the financial crisis resulted in a pension crisis as well. The high sensitivity of individual accounts to investment risk was in my opinion rightly mentioned in the Ageing Report.

In contrast, the impact of the financial crisis has been much more moderate for participants in collective defined benefit schemes. The advantage of defined benefit plans is that they allow for the sharing of investment risks by smoothing funding shortfalls (or surpluses) over various generations. This mechanism is also known as intergenerational risk sharing or intergenerational solidarity. The financial crisis has underlined the importance of intergenerational risk sharing by insulating plan members to a considerable extent from the fall in global stock markets. For example, in the Netherlands indexation of pensions may have been suspended and contribution rates may have been raised. But plan members have not been subject to an immediate fall in accrued pension rights or retirement benefits.

Ladies and gentlemen, I will conclude by summarizing my two main messages. 1) An important lesson of the Ageing Report is that a shift towards more funded pension schemes is essential in Europe and 2) countries should consider implementing such funded pension schemes in a collective way. In my opinion, the financial crisis has clearly shown that a reappraisal of solidarity in retirement provision is very much called for.

Thank you for your attention.

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