“Added value of variable retirement benefit”

June 2018

DSM

ORTEC FINANCE

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Recently the variable pension law was passed, which allows participants in a premium contract or capital agreement to choose a variable, venture capital pension. Participants who so choose can gradually purchase their pension in a collective, in which they can continue to invest after the retirement date. Also, they can spread risks over time. Stijn Spauwen is head Pension & Actuarial advice at DSM. For employees who earn more than € 100,000,00, DSM has a defined contribution scheme, and Spauwen investigated whether the new law is an improvement for that scheme.

"At DSM we implement a net pension scheme, with a DC-scheme in which participants can save. The saved capital can be converted into a fixed annuity ten years ahead of the retirement date. Now it is also possible to use that capital to purchase a variable retirement benefit. Our question was: does such a variable retirement benefit result in a lot of added value for the participant, compared to the fixed allowance that he or she could already buy from us? General investigations, including by Ortec Finance, showed that the variable retirement benefit certainly has added value compared to the fixed pension that is implemented by an insurer. But even a fixed payment by a pension fund is actually not a fixed annuity, because it can be both indexed and cut. Nor is it invested risk-free in the benefit phase. Together with Ortec Finance, we have tried to objectively compare the two variants, i.e. the Pension Fund variant and the variable retirement benefit, for the net pension arrangement with the specific composition and financial position of DSM, and to see where the added value lies."

"The variable retirement benefit is expected to result in slightly higher pensions."

Advantages of a variable pension

“Amongst other things, we looked at the legal requirements for the purchase rate which obtains if we want to convert the capital into a benefit for the net pension scheme. That must be done at an interest rate term structure with a VEV surcharge. The result is that as a participant, you pay a considerable amount to join the collective. You can get indexation, but if the coverage of your pension fund is not up to the required level and your indexation prospects are relatively limited in the coming years, you pay a considerable surcharge with little return. With a variable retirement benefit you don’t pay any surcharge. We therefore investigated whether in the specific fund situation of an ageing population there is a particular funding ratio level where you actually benefit from your VEV surcharge. From that moment on, the purchase of a “fixed” benefit in the fund leads to better results than a variable retirement benefit.

Our research confirmed that the difference between the ‘fixed’ payment by a pension fund and a variable retirement benefit is smaller than when you purchase a fixed annuity from an insurer without indexation and discount potential. The result falls between the hard nominal payment by the insurer and the variable retirement benefit. Furthermore, we saw that if a fund has low coverage ratios and can give little indexation in the short term, for participants is not very attractive to purchase a ‘fixed’ benefit from a fund where you pay the VEV surcharge. That only becomes attractive when a fund has such a financial position that you also get indexation for the price you pay, and that happens only at cover ratios of between 110 and 115%. The research confirms that at low coverage ratios of the Fund, it is beneficial to choose a variable retirement benefit. On the one hand because the participant does not pay the VEV surcharge, and on the other hand because you can directly off-set investment returns with the participant. A key assumption, however, is which investment mix is used for a variable retirement benefit. In case of an investment mix with a higher expected return, the pension outcome is higher than in the case of full indexation in the ‘fixed’ variant. If your starting point is an investment mix with a lower expected return (which can be substantiated because the duration of the benefit phase only is less than that of the entire fund), this need not necessarily be the case.”

Disadvantages

"A variable benefit also carries risks. If the returns are disappointing, you can not share the risks with the total fund population, as is the case when you purchase a fixed benefit from the funds' collective. Ortec Finance's calculations show that a variable retirement benefit is less stable than a fixed benefit from a fund. The variable retirement benefit is expected to result in slightly higher pensions (based on the same investment mix and the current financial position of the fund), but the odds of those varying considerably from year to year are also a lot higher.

The results are in line with what we and the sector expected. Now we are investigating how to implement a variable retirement benefit. The DSM net pension scheme applies to all Dutch DSM employees with an income of over a hundred grand. Those do not run into the thousands, so we are now investigating if it is feasible to implement this ourselves. If not, then the law indicates that a participant may choose to purchase a variable retirement benefit from a third party."

Research the possibilities

"Before you offer a variable retirement benefit, I recommend you set out what options a participant already has and what the pros and cons are. Then you determine whether it has added value to offer participants an additional option. If there is no evidence of that, then extra choices only serve to make it needlessly more complex. For this analysis you need calculation models. You can provide qualitative reasoning yourself, but you want to see that confirmed. And you want to quantify it: how much added value is there? Those models and capacities we do not have, which is why we do this together with Ortec Finance. Beside the calculation results, we learn to understand certain structures better by sparring with Ortec Finance's people . I am glad that they are able not only to quantify, but can also take part in thinking about the outcomes."

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