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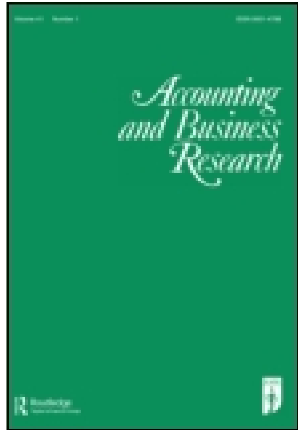

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# Discussion of ‘International trends in pension provision’

Manuel Peraita [a]

[a] Practising actuary and Professor of Pension Funds and other Retirement Institutions, University of Alcalá de Henares

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# Discussion of 'International trends in pension provision'

**Manuel Peraita***

I am a member of the International Actuarial Association but, of course, I am not representing the Association here. However, I sent one of my colleagues at the Pensions and Employee Benefits Committee a copy of the draft of Professor Barr's presentation, just to be sure that there would be no objections to my participation. My colleague made a comment that I will make mine. He said, 'Although the thoughts there are familiar to me, I found them expressed very well.' I feel the same. Accordingly, my comments must be seen in this framework, which is that I fully agree with almost all the observations made, and I will just make some comments on some of the issues raised.

Before that, I would like to raise one point I didn´t hear in this presentation: that is the difficulty, when we try to analyse international trends in pensions, derived from the fact that languages are different. That is very important because, for example, some of the keywords used in Spanish or French do not exist in English. You could look at the dictionary for terms like *prévoyance* (in French) or *previsión* (in Spanish) but would find words that do not capture what we understand by them. I don't speak German, but for sure they also have 20 or 30 terms in this area.

It becomes more complicated when the same term is interpreted differently. We talk about, let us say, a 'defined contribution plan', which is a very common term. Let us deal with a simple one because there are many different types of plan. What is mostly understood by 'defined contribution plan'? In Denmark they would say, 'We very much like defined contribution because you have a guaranteed benefit. So every year when you pay a contribution you know what pension you will get from that contribution.' They say this because they invest those contributions into insurance, deferred annuities, guaranteed, which are then combined with participation in profits afterwards.

If you speak in Spain of a defined contribution plan, it is just the opposite. The law says that defined contribution plans cannot include any type of guarantee. It is forbidden. Neither mortality nor even investment returns can be guaranteed in a defined contribution plan. Consequently the vision would be totally different. When you speak to a Dane, he will say, 'I have solved my retirement. It is all in defined contributions.' If you speak to a Spaniard with a defined contribution plan, especially these days, he will be crying!

I am not going to expand more on that but another example, which has to do with accounting, is a defined benefit insured plan, when an employer makes a promise of a benefit and insures it through an insurance company, using deferred annuity contracts. In Spain, the law says that the employer who does that has fulfilled his promises. Provided he pays the premiums that need to be paid every year, if the insurance company goes bankrupt then he does not have any responsibility for paying the benefits already insured. He has kept his part of the promise, which is buying the insurance. Of course, it could be discussed how he has chosen the insurance company and how the premiums were determined, but the law says if he pays the premium that has been asked, he has discharged his obligation.

In Germany, you could also insure a plan, but it is just the opposite. The law says that whatever you do, even if you fully insure the plan, you keep your responsibility; and if the insurance company goes bankrupt, you have to pay the benefits. These are totally different situations.

In fact, in IAS 19 there was a problem with insurance and the definition of assets, and the text which was issued in 1998 needed correction in year 2000 to cope with this problem of what insurance really means in different environments. As I say, internationally we have the difficulty of understanding the language and terms – not just words but what they mean in the legal environment.

I will now consider issues raised by Professor Barr in his presentation and, to make it easier to follow, I shall use the same order as him.

In terms of economic theory, and, more specifically, when we analyse the impact of demography

* The author is a practising actuary and Professor of Pension Funds and other Retirement Institutions at the University of Alcalá de Henares.

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on retirement systems, I fully agree, and have done so for a long time, that funding a plan through investment assets might lead to the same type of problems as when using a pay-as-you-go (PAYG) system. You need to have future production in order to allow the present consumption sacrifice to turn back into consumption capacity when needed in the future.

Possibly today it is easier to foresee problems ahead with PAYG systems and adopt measures to prevent them. Of course, there are always very passionate discussions when trying to introduce the changes needed for solving those future problems. The main obstacle to implementing corrective measures is that often the problems are perceived to be so distant in the future that solutions are difficult to implement today. But, in general, most countries are taking measures to deal with those problems. Spain has done so. To some extent France and Germany have acted similarly.

However, in the case of asset accumulation, volatility is much higher. Sometimes the problems in the future are experienced today. From time to time, we can observe compulsive behaviour of the financial markets as a result of euphoria or panic reactions of their agents. In that environment, when a future problem, let's say 15 years in the future, is foreseen, it might generate immediate reactions and that problem might have consequences today. Let's say – it has been mentioned in today's presentation – that as a consequence of legislation there is a shift in the investment decisions of pension funds that has an influence on prices, producing a certain fall in share prices and an increase in fixed income securities. But such movements don't have to be driven by changes in legislation; there are other situations that push investment decision makers to do the same thing at the same time. It could just be that they all foresee the same problems or opportunities ahead and take the same decision today. Generally, the markets move very much together. The price paid today for something when demand is very high, is probably a high price. That does not guarantee that tomorrow's prices are going to be so good when the assets are sold, especially if everybody tries to sell them at the same time.

Another characteristic of funded types of pension arrangements is internationalisation. That has a negative effect on the local economy and production. I remember having read in the 1980s, in an economic review, that 40% of the assets of the Dutch pension funds at that time could purchase the whole stock market of the Netherlands. So pension funds need to invest outside their home country. And of course possibly in pure economic terms, and general equilibrium, that does not have a strong effect, but for individual countries and their production it has an effect. It might possibly have the effect of accelerating investment abroad, which is good for development of less developed countries, but it is also good for increasing competition.

I am not going to enter into all the economic discussions that this could lead to, but we could focus on the fact that stronger foreign competition is one of the factors behind shorter working careers because it forces companies to reduce their labour force. Even if an employer can keep its workforce, it will be in a weaker condition to be able to fund its pension arrangements properly.

Concerning funded plans that need to invest abroad, in the UK this matter was dealt with by the courts (Cowan v Scargill, 1984) when the coal miners did not want their fund to be invested in competitive energy sources – or, I think, in South Africa at that time. There is a clear court decision saying that the trustees have to act in the interests of the participants. But then again, there is the interpretation of what is 'in their interests'. That seems to mean the best investment return with a certain level of risk. But now a concept that is starting to be widespread is 'responsible investment', that is investments influenced by environmental, social and governance (ESG) considerations. Do we have to invest only in emerging economies? What are the labour conditions in those countries? Is there social dumping, in economic terms? Is that type of investment working in the interests of the UK participants? I think there are interesting issues here that possibly should be reconsidered by the partners of funded plans.

Very often early retirement is not a voluntary decision of an employee who can say, 'I can take early retirement, and I will have a pension that satisfies me', but rather he is pushed to retire because he has become 'obsolete', he no longer has the skills needed, and no-one wants to invest in his retraining. And how difficult would it be for him at 50 or 55 to acquire new skills, new knowledge? Who is investing in that? These are problems that are not purely 'people live longer, let them retire later'. It is a more complex problem that possibly should be addressed.

Considering further the case of mandatory retirement, I note that in Spain today, for example, the normal retirement age is 65, and early retirement starts at age 60. But the practical pre-retirement age is between 52 and 54, sometimes 50, in many sectors. Companies do not lay people off. They have arrangements for employees to stop working but continue to be paid up to age 60-61 an amount of 80% of what their salary used to be. Then they retire on the public system. It is complicated to adopt a solution of saying, 'Let us just retire later'. This requires a much more complex analysis before we can identify a workable solution.

Another issue that I would like to comment on

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refers to the 'culture' of participants of defined contribution plans that would allow them to choose an adequate investment strategy. In the 1980s and 1990s it was very often assumed that the best future arrangements would be defined contribution plans that allow the participant to choose the investment strategy that best suits his career profile. However, very frequently these plans yield very poor results, especially in Latin America, and we hear some experts saying, 'The only problem is that participants possibly do not have the culture required to determine the strategy that best suits them.' I do not know whether we should just focus on that 'culture', or if we should add elements that refer to confidence in the system. If we consider, for example, the evolution of the last six months, I am not sure whether the amounts accumulated, or lost, in some of the plans are to be considered as the consequence of lack of culture of the participants, or if we should blame other events that have happened, very often related to issues of governance, regulation and supervision of some of the institutions involved. I think there will certainly be new developments in these areas in the near future.

In the past, there have been incidents in the UK which have influenced legislation and governance of pension institutions. There was the Maxwell case and other situations where the pension plan participants were not to blame. Possibly it's more the functioning of the whole system that has to be better regulated or controlled.

As Professor Barr's presentation was mostly on economic aspects and the international background, I have not prepared much to say on accounting but, speaking as an actuary, I fully agree that when we do our projections, when we perform our valuations, there is always a long-term smoothing activity implied in our calculations. We talked about time horizons. It is very hard to combine a single number with the full spectrum in time over which things are going to happen. This is a challenge for actuaries, and I think it is also going to be a challenge for the accounting rules.

There is a current trend towards eliminating every smoothing possibility in accounting because of possible abuse, and that possibility of abuse must be recognised. It would be very difficult to maintain an accounting system on pensions that does not take into account this time-horizon effect. A single number needs to be clearly supported by disclosures that show how the events that underlie it are expected to happen over time.