"Adjusted actuarial cost price conflicts with transparency requirement"

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Suppliers of financial products are increasingly faced with the quest for transparency about their offering. Transparency is needed (not sufficient) to allow buyers to judge whether such products meet their needs. The quest for transparency also applies to pension funds.

Transparency is not only about providing information ("saying what you do"), but also about consistency ("doing what you say"). Applied to pension funds, this means, a.o., that pension promises are adequately funded. Unfortunately, this is not always the case and it sometimes looks like quite some people in the pension sector do not even want it, or do not know what it means. This, at least, is the impression one gets from many discussions about pension costs in general and the so-called 'adjusted actuarial cost price' in particular.

An example of this is the recent plea by the (Dutch) Actuarial Society (AS) for permission to set contributions to defined benefit plans on the basis of that 'adjusted actuarial cost price'. This implies discounting of future liabilities on the basis of the expected (uncertain) return on plan assets rather than a risk free interest rate. If expected returns are higher than the risk free rate, contributions based on the 'adjusted actuarial cost price' will be lower than the actual cost price. Without a warning that this increases risk beyond employees' expectations, they will actually get a different product than they assume. Things would be different, if uncertain streams of returns would be as valuable as certain returns and investors would be able to systematically outperform markets. Unfortunately, this is not so. That is why market based valuations represent 'fair value'. It looks like the AS does not want 'fair value'.

The AS may be right, though, in suggesting that employers and employees simply cannot afford the level and volatility of the cost price of today's pension promises. It leaves them no other possibility than opting for a different product (i.e. a lower or a less certain pension). Those who prefer paying less than the cost price without informing their stakeholders (employees, deferred members, pensioners and 'sponsors') that they will be receiving different products than they expect, are actually fooling them. They are making things even worse by suggesting that the recovery plans that will be needed for pension funds that lose their reserves or even become underfunded may be based on the assumption of interest rates that differ from market rates. Neither transparency, not sound pension funding are served by this. It merely leads to more uncertain pension benefits. Maybe, that will prove inevitable anyway. It would be wrong, however, to change the product without first thinking about a better design for it. Rather than hiding the true cost, discussions about funding should be combined with a discussion about new and better products.

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