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# Proactive planning

as the answer to consumer  
and labor market uncertainty  
in the Netherlands

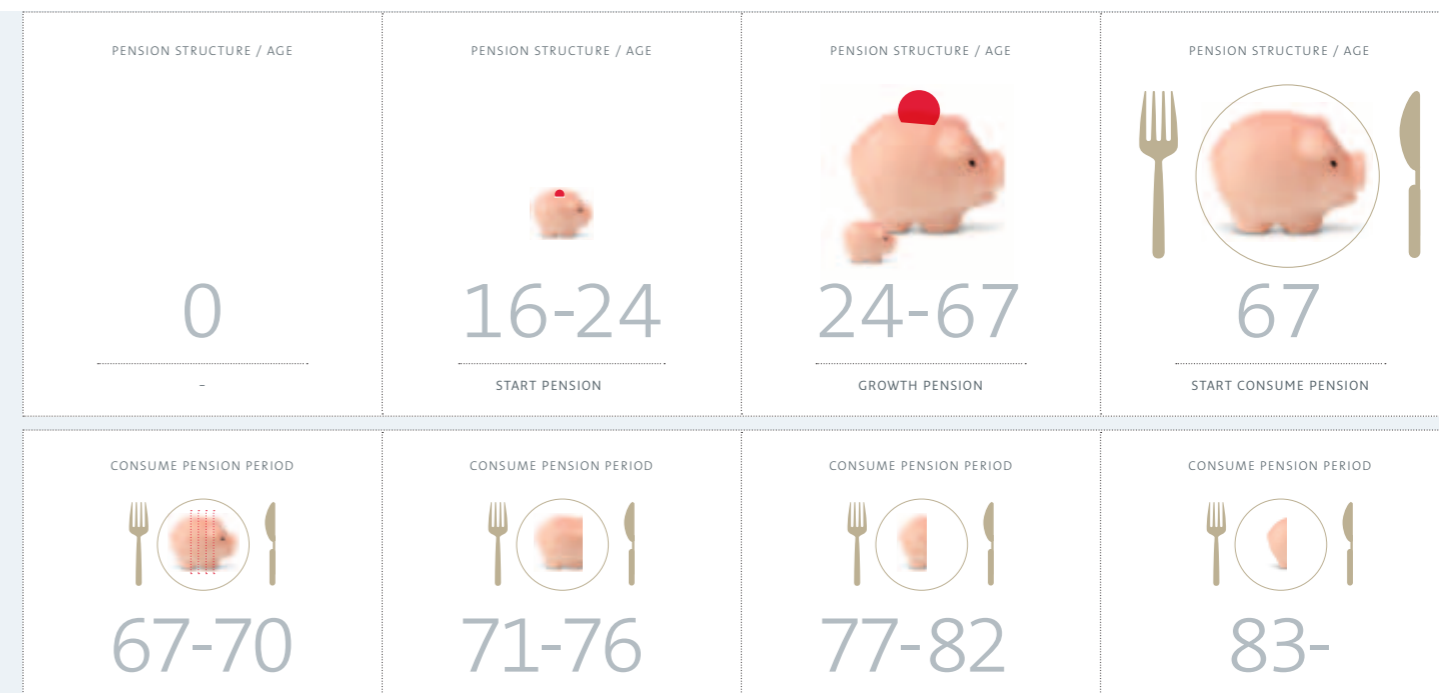
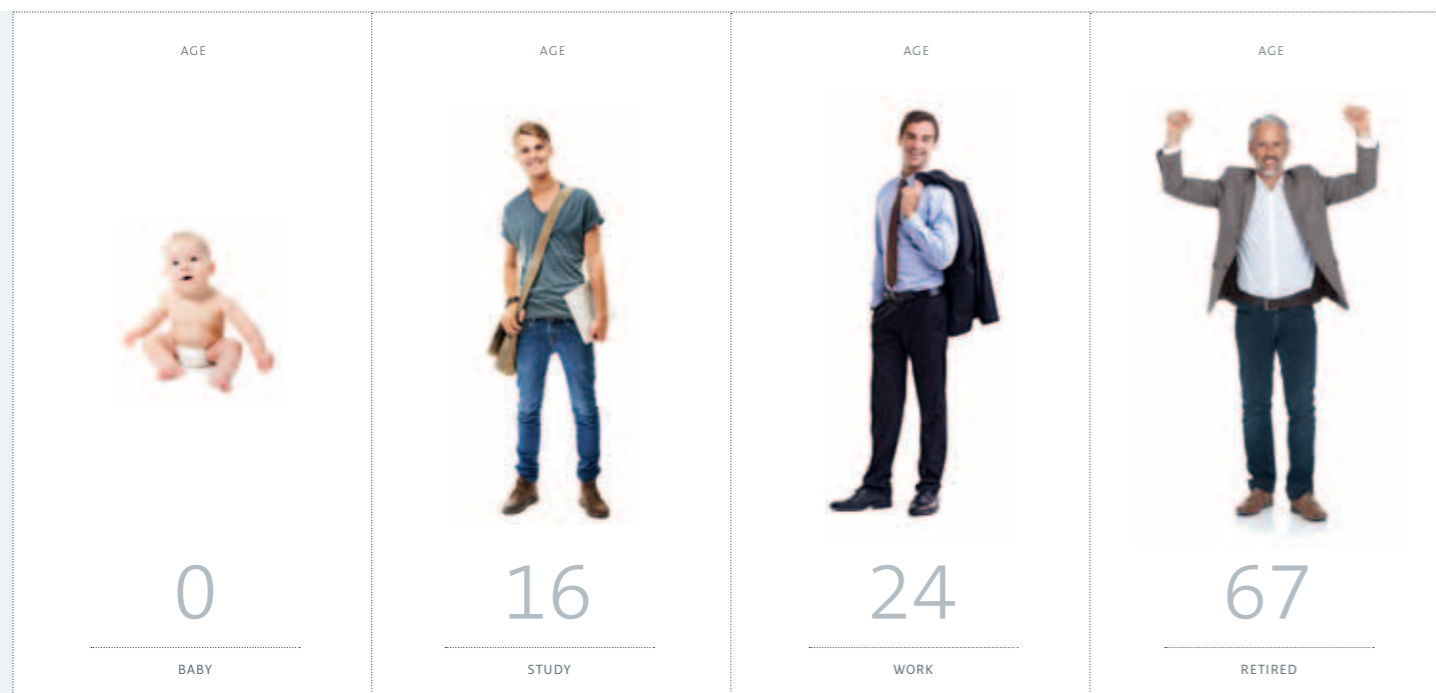
A six pillar approach to financial planning during an individual's life-cycle can make a significant contribution to addressing uncertainties. To be able to seize the opportunities in this domain, existing institutions will have to roll up their sleeves.

PENSION STABILITY GROWTH



## SIX PILLARS (INSTEAD OF THREE)

- I THE GOVERNMENT'S BASIC STATE PENSION (AOW), SURVIVING DEPENDANTS ACT (ANW) AND THE WORK AND INCOME (CAPACITY FOR WORK) ACT (WIA); II THE EMPLOYER'S GROUP PENSION;
- III INDIVIDUAL PENSION OR ANNUITY; IV SAVING, INVESTING AND INSURING;
- V EQUITY/DEBT IN OWN HOME; VI LABOR (HUMAN CAPITAL)



**The idea in brief**

An integral vision and approach to planning finances and employment during an individual's life-cycle can make a significant contribution to lowering uncertainties. Due to new technology, we are in a better position to form a clear picture in advance of the impact of potential events that affect income, health and employment and to develop a plan tailored to the individual. The new technology provides new forms of financial planning, a better estimate of someone's (earning) capacity and additional opportunities to take out insurance in advance. This also makes it possible to develop better incentives designed to limit risks in advance.

To be able to seize the opportunities in this domain, existing institutions will have to roll up their sleeves. This will enable employers' and workers' organizations to proactively operate with a focus on increasing employability and preventing unemployment and occupational disability. This demands attention to the existing organization of institutions and the application of new incentives, and a different role for government. Changing institutions takes a great deal of time and it is therefore good to take the first step, thinking about this, sooner rather than later.

**Uncertainty among households increasing**

Households in the Netherlands are faced with increasing uncertainty. Government is shifting risks to its citizens and the facilities on which its citizens can rely are being scaled down. A permanent job is less certain in a rapidly changing

economy. This uncertainty is reflected in higher (long-term) unemployment compare to the beginning of the Great Recession in 2008. The uncertainty among households is also increasing, because fewer permanent employment contracts are available. The number of temporary employment contracts has increased considerably and the number of self-employed has risen significantly. Social security has been cut back in recent years and is therefore less effective in terms of its operation as a safety net. These developments can be expected to become trends for the future as well.<sup>1</sup>

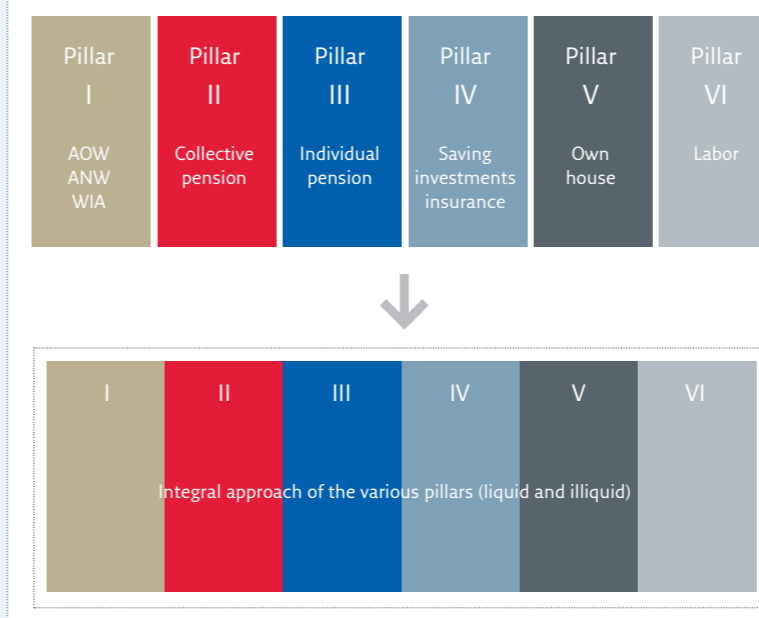
**An integral life-cycle vision is required to better anticipate uncertainty**

Consumers are generally forced to respond to uncertainty when they experience its negative effects, for example due to the loss of their job, occupational disability, divorce, or the sudden death of a family income-earner. It is important that the shift of responsibility from government to consumer is perceived on a timely basis by consumers. The increasing uncertainty among households creates a greater necessity for instruments to deal with this. However, consumers are as yet unaware of the need for such instruments. Behavioral scientists are considering how to better prepare consumers should they be faced with life-cycle events concerning finances, work and their own household. Better insight into their own situation and the perspective for action are required to assist the consumer. Integrated financial planning that includes all household income and equity components provides opportunities to develop a good overview of the income position and risks

over time.<sup>2</sup> A six pillar approach is required to develop an integral view of income, finances and work over time. This is a broader approach than the prevailing three-pillar-based pension approach by expanding it to include the equity domain (held at financial institutions and in the home) and at work. The six logical pillars in this model are as follows: I. The government's Basic State Pension (AOW), Surviving Dependants Act (ANW) and the Work and Income (Capacity for Work) Act (WIA); II. The employer's Group Pension; III Individual Pension or annuity; IV Saving, Investing and Insuring; V. equity/debt in Own Home; VI. Labor (human capital). This is illustrated in Figure 1.

The pillars differ in terms of degree of liquidity over the life-cycle and in terms of composition, the degree to which it consists of equity or debt. Furthermore, income is a flow variable and equity is a stock variable. During the life-cycle, the income acquired through labor is converted into consumption or equity. For example, a purchased home is illiquid and at the beginning of the life-cycle primarily stocked with debt; 30 years later, the home primarily comprises equity, but still remains illiquid. At the beginning of the life-cycle, the pension is stocked with equity and at the end of the life-cycle, the equity is primarily invested in fixed-interest debt securities and can only be converted into liquid assets from a certain age. The pillars saving, investing and insuring are largely liquid and primarily consist of the current account balance at the bank, equities and bonds.

Figure 1: the six pillars



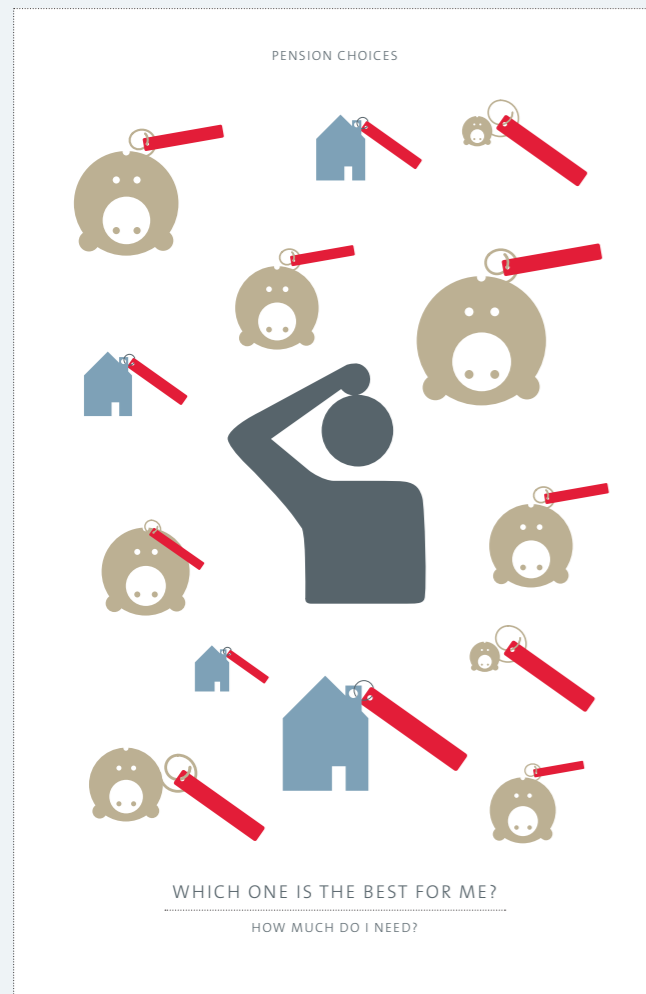
**Essential to integrate the Labor factor into the approach**

Labor is the natural source of the other pillars. During working life, the Labor pillar transforms an illiquid form of capital (human capital) into a liquid form, salary or income, by means of an employment contract or an assigned job for a self-employed. When you are young, the value of this human capital is difficult to estimate. As you increase in age, a track record increasingly emerges that can be used as a basis for estimating the value of the human capital. Staffing agencies are well-equipped to determine the labor market value of candidates.

Human capital is the most important source of income. Before retirement it needs to be protected from shocks during the labor career through life insurance. At retirement and until death what is needed is protection against the risk of outliving savings.<sup>3</sup> The sixth pillar (Labor) currently is understood to include: mental value (study), vitality (health) and salary.

**An integral vision requires individual planning across the entire life-cycle**

The provision of individual advice to consumers has become more complex with the increase in individual responsibility. This advice comprises two key developments. First, the sector is undergoing professionalization and is subject to more stringent regulatory requirements (duty of care). Second, increased use is being made of technology and



digitization to substantively improve advisory services and make them more accessible (e.g. pension tracking portals and robo-advice). Much of the advisory services was focused on selling specific pension, saving, investing or mortgage products. As a response to these sales-driven advisory services, the regulatory duty to care criteria were (rightly) increased. Often, we observe that the advisory services do not have much of an integral character and – in part due to the sales-driven approach of the past – are highly fragmented, for example, with a sole focus on financing a home or providing a pension. To be able to better deal with uncertainty requires an integral approach that matches the key aspects concerning income and wealth creation; an approach that matches the six pillars in Figure 1.

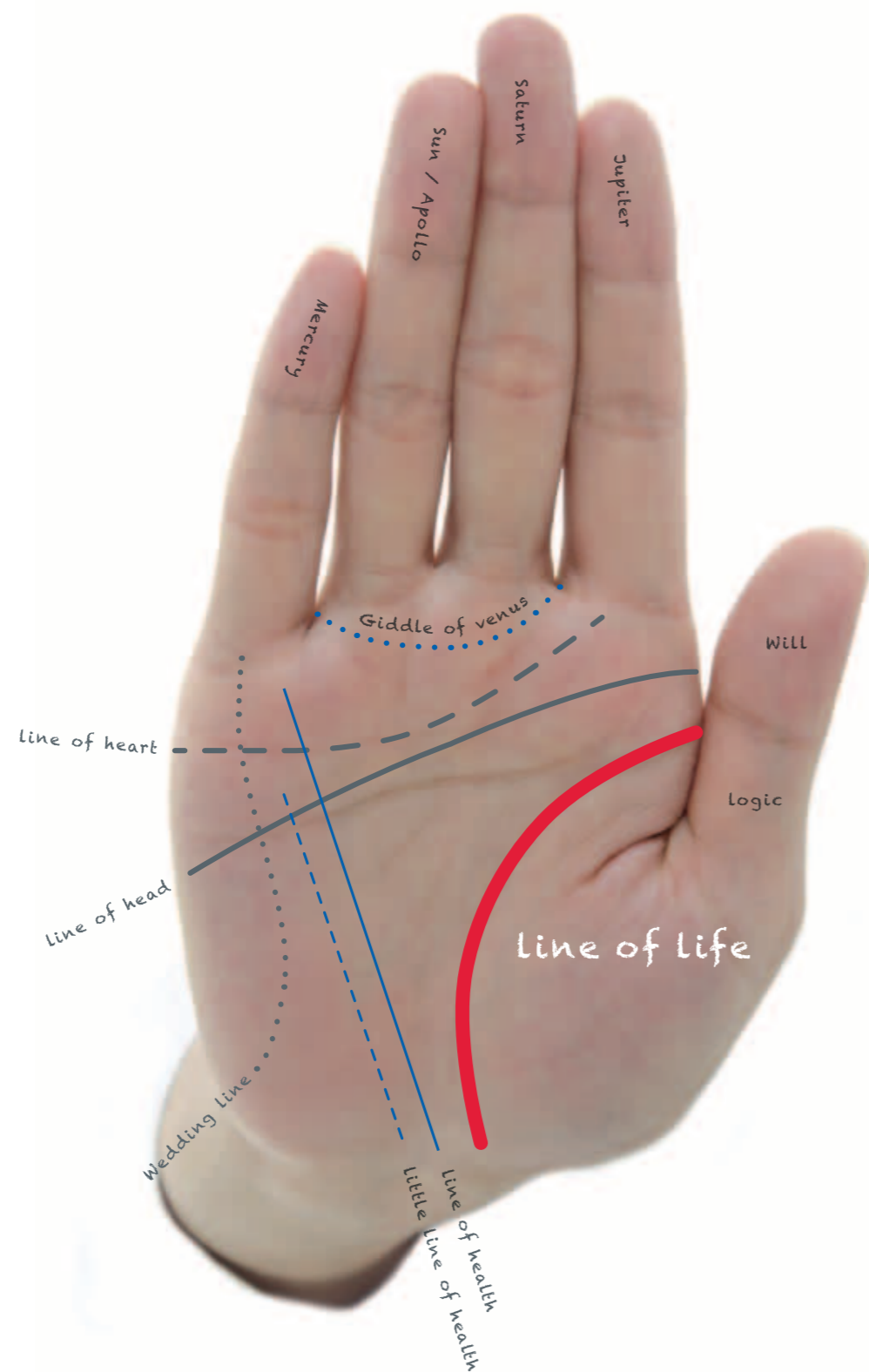
Two trends are important to help move this a big step forward: 1) better insight into consumer behavior and technological opportunities to exploit this behavior; and 2) availability of data about the consumer's various income and assets. In setting up an integrated life-cycle plan, it is possible to make use of the experience from new applications that provide information about people's behavior so that the experience of one consumer becomes useful to another consumer (peer-to-peer). The advance of digitization makes access to data much easier. Pension information in the first, second and third pillars is often digitally accessible. Furthermore, banks and other institutions provide information about the current account and wealth creation. In addition, information about mortgages and housing values is also available. The Dutch Tax and Customs Administration assembles most of this information. The consumer can view most of this data via DigiD. There are also developments in the labor market domain focused on evaluating the employability and earning potential of an employee or self-employed. There is enormous potential of providing the consumer with better insight into his situation if this information were to be pulled together. Technology furthermore makes it possible to make this facility cost-efficiently available. But a lot still needs to happen to reach this point. In a recent report,<sup>4</sup> the Netherlands Authority for the Financial Markets (AFM) expressed the hope that suppliers and other stakeholders will join forces to come up with solutions. Furthermore, key issues in relation to duty of care, roles and responsibilities need to be resolved.

PENSION CHOICES / SOLUTION



PENSION TAXI

WITH COACH HELPS YOU TO YOUR PENSION  
ON YOUR OWN WAY



## ARE YOU SURE?

ONLY TIME CAN GIVE THE ANSWER ...

### The example of the self-employed

The inclusion of the sixth pillar is also essential to understand and ultimately to better service for the specific needs of individuals or groups of individuals. Take for example the case of the self-employed. The self-employed is someone who has a lot of intangible assets. The value of its human capital is determined by its social network and workmanship, which are difficult to estimate. The self-employed can know long periods of no income. Income smoothing with self-employed therefore work differently because they do not have a continuous flow of liquidity that they can move into the future.

For that reason, the self-employed can be seen as risk bearer, who shares risks within projects. Success for them is indeed not granted at any rate and even the successful among them rejoice telling stories about their many failures before success finally arrived. Most self-employed will need to re-invent themselves at least once in their careers, either to pursue another venture or to reinsert back into the employed world. The self-employed has, as it were, shares in himself and may decide to pay dividends to himself for his future self and the dividend then be managed by a pension fund. How much dividend it pays to himself that rules can be drawn on in terms of absolute amount for a certain income, but the self-employed has the discretion to deviate from the rules when needed.

The end result is that as a group the self-employed is one of the most vulnerable at retirement. A recent survey by APG, Harvard University and Erasmus University Rotterdam<sup>5</sup> shows that instability of income, lack of conviction of need to save and distrust in the financial markets and a perceived need to maintain control over savings are some of the main potential obstacles in saving through pension funds for the self-employed. These findings show that the type of uncertainties revolving around a self-employed career could be very different that those facing the employed and should be therefore incorporated when designing pensions policies and products for such a group.

### All for one, and one for all

The sixth pillar feeds pillars one to five, through taxes,

contributions, savings and other life and financial decisions. Due to the increased uncertainty and reliance on individual decisions, it is more important than ever that the other pillars also reinforce the Labor pillar during the life-cycle. Various examples come to mind:

1. Study loans whereby the pension assets can be used as security reinforce a person's human capital. For older individuals, such loans could finance a switch to a second career. The incentives are also better than they are for the current forms of government study loans. Individuals are less likely to choose study programs with little labor market perspective if they know that their pension serves as security.
2. On the investment side of pension funds, social impact bonds could make a contribution to work resumption or helping people move from work to work. By investing in work resumption projects in their own sector, workers' job opportunities can be enhanced.<sup>6</sup>
3. Health impact bonds are bonds that affect people's vitality. For a health impact bond, a private party finances the intervention at the front end, whereby the performance of the intervention is agreed upon in advance. In case of a successful intervention, there is a gain in health and cost savings. The investor's return is paid from the cost savings. Investments can limit occupational disability this way.<sup>7</sup> Furthermore, supplementary products in the event of occupational disability can be focused on revitalizing people.
4. For the self-employed, a carefully designed scheme of limited specific purpose withdrawals from pension savings may assist them in periods of liquidity duress over their life cycle.<sup>8</sup> These schemes may compliment the role of the abovementioned social impact bonds, at times when the self-employed need to re-invent themselves.

### Proactive approach instead of response afterwards

The creation of public and private facilities for social security, as well as pensions, were an after-the-fact response to a changing labor market and society. As such, facilities were a solution to issues that emerged as a result of innovations in the economy and society. At the end of the 19th century, our forefathers were also confronted with an industrial revolution that put the relationship between the factor Labor and the factor Capital under pressure.

Their solution was to organize solidarity circles that were responsible for the ex-post redistribution of income and where everybody paid the same price. Solutions were developed for people who became sick, unemployed or occupationally disabled. The first solutions were put forward by the trade unions and socially committed entrepreneurs. These solutions were later institutionalized by government.

The current industrial revolution is based on the technological development of the information and communication technology sectors. This technology ensures that we know more in advance as to who is exposed to what risks. This hampers the organization of solidarity circles. The traditional way of organizing solidarity afterwards no longer works, because it is not considered fair in the event of ex ante transfers. Indeed, the veils of ignorance about many risks has been lifted: Why should I have to contribute to another's risk when I know that my exposure to that risk is much less than that of the other? The technological developments of the fourth industrial revolution will increase the uncertainties for the Labor factor. It is not

entirely clear as to who will benefit from this industrial revolution. It is possible that many jobs at the lower end of the labor market will be automated; it is also possible that many jobs in the mid-segment will disappear (accountants, real estate agents, etc.).

The solution to this uncertainty is to stimulate risk sharing. For example by organizing markets in which everyone in advance partially insures himself against unemployment and occupational disability risks. Why do these markets not just come about by themselves? First of all, this is due to risk selection. Everyone who thinks they run a higher risk insures himself against that risk causing the insurance to become so expensive that it is no longer attractive. Second, there are market imperfections due to human behavior. People always think that someone else will be affected by illness or occupational disability. The obligation to take out insurance against the risk of unemployment (income) and occupational disability could make a contribution to this. There is a role for government here to facilitate this development. In other words, we should think about this in advance, instead of solving this afterwards.



### Who will take up the gauntlet?

The fact that the government is scaling down in the area of social security demands the development of institutions that give employees and employers better incentives to get and keep people in employment. This time, not institutions that make after-the-fact arrangements (at the time of unemployment), but institutions that respond proactively on the basis of changed expectations and that think ahead, in advance of the time of unemployment. The institutions in the domain of public and private social security benefits are faced with a tremendous challenge in terms of maintaining their relevance. An important aspect in this respect is that they must provide an infrastructure that supports consumers to better manage the risks coming their way. Providing integral life-cycle planning assistance is part of this, as is the provision of facilities that contribute to increasing employability on the labor market through education and further training, and the provision of collective (public or private) facilities in which consumers can share or mitigate risks. For pension funds, insurance companies and (other) suppliers of financial products, there are opportunities here in assisting consumers and offering quality and safe long-term investment opportunities. The integral approach to planning, including wealth creation, and promoting employability on the labor market throughout the entire life-cycle, makes this a challenging domain for employers' and workers' organizations, and the organizations that support them.

Pension providers are extremely well-positioned to support consumers with their long-term financial planning and wealth creation. In this respect, they can fulfill the role of trusted advisor and provide access to institutional wealth creation opportunities to consumers. Support of the consumer requires large investments in reliable platforms. Who will take up this gauntlet?

As responsible investors, pension providers fulfill an important role. In this respect, they can devote specific attention to the S in ESG (Environment, Social, Governance) policy, social investments. For example, they could invest in social impact bonds for initiatives designed to help people move from work to work. In addition, there are also health impact bonds that reinforce people's vitality. In addition, as investor, they could be a driver to have the risks of fixed contracts

repackaged, so that these risks can be better distributed in advance, as a reinsurer of the risks of fixed contracts.

Furthermore, new unemployment and occupational disability insurance vehicles require employers' and workers' organizations and government to assume a different role. Government will have to act as facilitator through means of legislation so that the risks that the consumer is unable to carry himself continue to be insured and where necessary, the principle of mandatory participation is applied. Employers and employees will have to be prepared to bear the costs of these facilities, so that employees continue to be employable and employers can keep their workforce up to date in terms of knowledge and health. Social Investment Funds 2.0 may be required that organize the unemployment benefit payments and the work-to-work initiatives. For that matter, the implementation of these new facilities could very well be left to the market.

1. See De Beer, P., 2016, De arbeidsmarkt in 2040 (The Labor Market in 2040): Ingrijpende veranderingen, maar ook veel continuïteit, AIAS-studie (Drastic changes, but much continuity as well, AIAS Study). Harchaoui, S., 2016, Health impact Bonds - An Introduction, Society Impact.
2. Lapperre, P. and A.G. Oerlemans, 2015, Next generation pensioenplanning: zelfmanagement biedt kansen voor aanbieders (Next generation pension planning: self-management offers opportunities for providers), Het Verzekerings-Archief, Number 4, p. 221-227.
3. See Roger G. Ibbotson, Moshe A. Milevsky, Peng Chen, CFA, and Kevin X. Zhu, 2007, 'Lifetime Financial Advice: Human Capital, Asset Allocation, and Insurance.' *Research Foundation of CFA Institute Monograph*.
4. AFM, 2015, Neem drempels weg opdat Nederlanders in actie komen voor hun pensioen (Remove thresholds to enable Dutch citizens to take action on their pension), October.
5. 'Save More Today: Improving Self-Employed Pension Savings In The Netherlands', 2016.
6. Phlippen, S., 2016, Social impacts bonds zijn een breekijzer voor bureaucratie (Social impact bonds are a lever for bureaucracy) - See more at: <http://www.economie.nl/weblog/social-impacts-bonds-zijn-een-breekijzer-voor-bureaucratie#sthash.FnWShYGd.dpuf>.
7. Harchaoui, S., 2016, Health impact Bonds - An Introduction, Society Impact.
8. See Valdes, S., 2004, 'Improving Mandatory Saving Programs.' The World Bank; and García-Huitrón, Manuel, 2014, "The Role of Annuities, Partial Lump-Sums And Special-Purpose Withdrawals In Pension Design. *NETSPAR Masters Thesis*.