An Outsider's View on the Dutch Pension Reform

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This report is prepared for the ICPM Discussion Forum in Amsterdam October 15-17, 2017 by a group of international pension experts under the Research Committee of ICPM, the International Centre for Pension Management. The report is based on 14 informal interviews of Dutch pension experts and key stake holders in the Dutch pension system conducted in the fall of 2017. The goal of the report is to describe the background for the pension reform as well as the reform proposal from an international perspective. The group's assessment of the reform will be published in a different paper. The report reflects commonalities of these interviews subjectively selected and adapted by the group.

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Funding Crisis

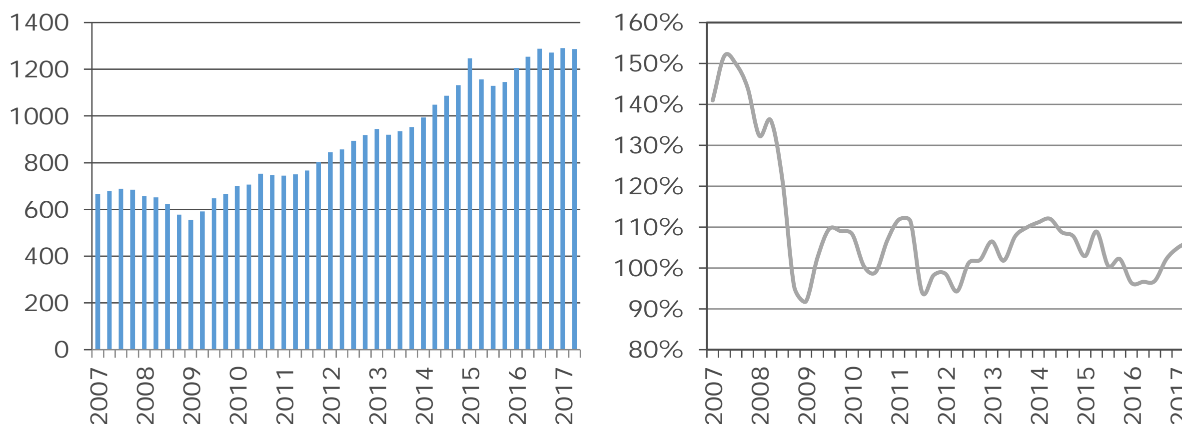
The Dutch pension system is trapped in an easy to understand – but difficult to get away from – dilemma: *Is a pension an insurance product or an investment product*?

In numeric terms, the Dutch pension system has never been richer (fig 1.a) having doubled assets since the financial crisis in 2008. Despite this, funding ratios of Dutch pension funds (fig 1.b) have not recovered to pre-crisis levels since discount rates are linked to market rates[1] (and not expected returns).

$$\text{Funding Ratio} = \frac{\text{Market value of assets}}{\text{Liabilities discounted at (modified) market rate}}$$

In the wake of a series of extensive stimulus packages from the European Central Bank, European rates are very low, exerting a sustained downward pressure on funding levels. Simply put, capital requirements have risen faster than assets forcing most Dutch pension funds at – or below – the minimum funding ratio of 105.

FIGURE 1 (A) TOTAL ASSET OF THE DUTCH PENSION FUNDS (bEUR). (B) AVERAGE FUNDING RATIO OF THE DUTCH PENSION FUNDS



Source: Dutch Central Bank (DNB)

[1] The Dutch pension system is described in detail in *An Outsider's Summary of the Dutch Pension System* provided by the working group.

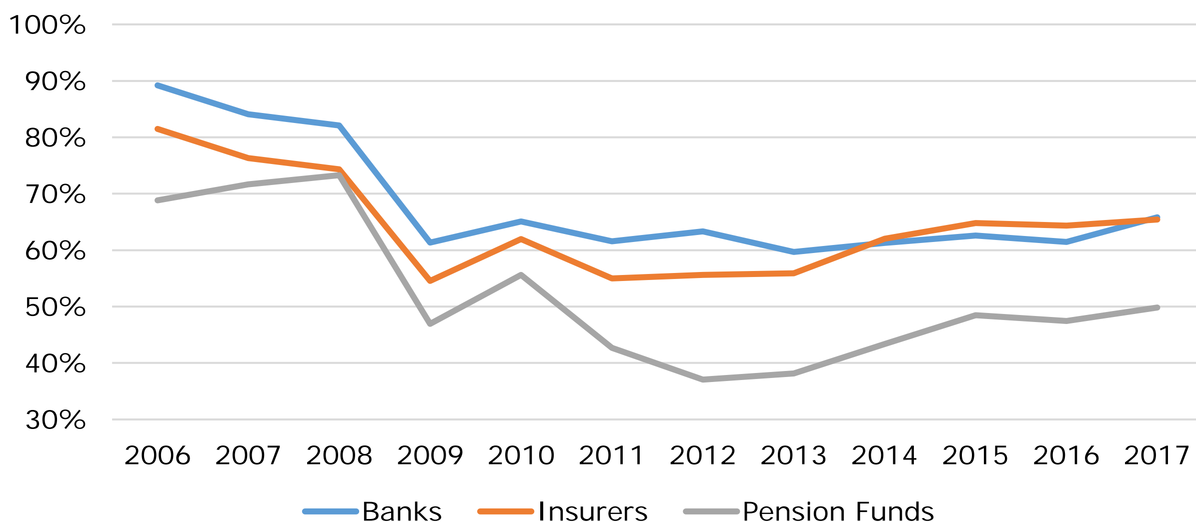
A direct consequence of the funding crisis has been that most pension schemes have not been able to fully index pensions since 2008 – neither pensions in accumulation nor pensions in payment. Some pension funds have even been forced to cut pensions to meet funding requirements.

Unsurprisingly, this has led to a general loss of confidence in the pension system, cf. Fig. 2. This negative sentiment is one of the strong driving forces for reform. The negative attitude towards the pension system falls in three categories:

- Young people feel they have a bad deal: Contribution rates have been increased but they fear the system will run out of money before their time.
- Older workers and retirees react to booming assets and are dissatisfied that pensions are not indexed – sometimes even cut.
- The retirement age has recently been raised – and will be linked to further longevity improvements in future.

The general sentiment among stakeholders is that the battle for public opinion is lost. The pension system is trapped in a negative narrative of pension cuts and lack of indexation unable to use recent years' positive investment results to regain confidence. To some, the main objective of reform is therefore to rephrase the "pension narrative" into a positive story more than fixing fundamental problems.

FIGURE 2: TRUST IN FINANCIAL SYSTEM: BANKS, INSURANCE COMPANIES & PENSION FUNDS



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Source: Dutch Central Bank (DNB)

Current Status of the Reform

A commission appointed by the Dutch government to evaluate the pension system concluded in 2010 that a reform was necessary. A reform proposal was put forward already in 2011 but was never implemented. Negotiations have been ongoing since then.

According to Dutch custom the pension reform is negotiated between employers and employees ("social partners"). The pension reform is negotiated under supervision of SER – the Social Economic Council – and will only reach the political level at a very late stage. Eventually the reform will be passed through parliament and enacted in the Pensions Act.

It seems that negotiations now are close to being completed but there is still uncertainty that agreement will be reached. Recently, social partners have failed to deliver a solution in two other areas indirectly related to pensions.

Even if social partners can agree, there is uncertainty if it will eventually pass the political level: After the general election in March a new government is still being negotiated – including its stance on pension reform. The coalition expected to form government has very recently announced they will postpone a decision on pension reform until later.

Fundamental Drivers for Reform

The more fundamental driver of reform is societal change. Labor mobility is increasing; between employers as well as in and out of self-employment. Currently about 1 mill. workers are self-employed out of a workforce of 8 mill. and the pension system has very little to offer them. A worker who leaves an ordinary job can continue contributions voluntarily for a period of up to 10 years – in some case only up to 3 years.

This leaves large groups with insufficient provisions for retirement in a system which was basically designed for workers to stay with the same employer for their entire working career.

There is general consensus that to fix this requires abandonment of the *Doorsnee* premium principle – the level premium system. In the current system pensions are accrued independently of age, ie. a young and an old worker receives the same pension entitlement for the same contribution.

From an economic point of view younger workers should earn a higher pension than older workers for a Euro contributed due to the time-value of money. But this is not the case in the Dutch system where pensions are accrued at a uniform rate, that is, independent of age. To accommodate more complex working careers, hence more volatile contribution flows, pensions must accrue in a fairer way – actuarially as well as financially – to avoid moral hazard in the system.

Economically, the level premium means that workers in the middle of their careers have earned implicit claims on attractive, future accrual rates which are not capitalized in the system. The distribution of this hidden deficit is probably the hardest technical challenge and must be resolved in the final reform.

The problem with the level premium system is exaggerated by inconsistency in the parameters set for computing accrual rates. Premiums are based on (modest) expected return assumptions exceeding the discount rate which in general is in favor of older workers. In the public debate, the level premium system is perceived as unjust by younger workers who feel they bear an unfair burden of the crisis.

Brief summary of the current system

In the current system, employers and workers pay a fixed fraction of wages to the pension fund, typically 15 pct. of total compensation. Payment is usually split 50-50 between employer and employee but 2/3 employer – 1/3 employee is also common. A full contribution typically earns an annual pension benefit between 1.6 and 1.9 pct. of current income. The benefit is notional and simply added to previous years accruals to aggregate to the eventual pension.

The pension benefit is a liability to the pension fund which must hold assets to ensure timely payment of future pensions. This is characteristic of an insurance company and the reason why the Dutch regulator (and European regulators in general) impose strong capital requirements on pension funds to protect benefit

claims. Major risks like investment risk and longevity risk therefore are risks to the pension fund.

The challenge to the Dutch system is that pension funds are more like cooperatives than insurance companies. In other words: Members are not only customers of the fund – they are also the owners. Since members savings are already in the fund, the sources to provide new capital to the pension fund are all painful: Increases of contributions, cancelling of indexation, or cutting benefits.

The reform proposals

In essence, the reform will alter liabilities from claims on (future) benefits to individual savings accounts. Each member of the fund will hold a personal account reflecting the value of their share of total assets. Over time, the account will accumulate with the investment performance of the fund as well as new contributions.

In retirement, members take out pensions by drawing down the account. To ensure a life-long income stream, a risk-sharing mechanism is added: Surviving members inherit the (personal) accounts of deceased members. This will produce an annuity-like income stream to retirees reflecting realized longevity among members of the fund. Essentially, an annuity stream on realized mortality – not an annuity stream guaranteed by the pension fund.

PPR-VA

The new pension scheme is coined a Personal Pension with Risk-sharing – or PPR. "Personal", because accounts are individual, "risk-sharing" because longevity risks are shared between members.

Two variants are being discussed: The product just described where the individual bears the entire investment risk (VA), and a more complex product where a second layer of risk-sharing of investment risk is added (CB).

In the first variant, "VA" is short for variable-annuity since the benefit stream strongly resembles the benefit stream from a variable annuity.

PPR-CB

In the second variant, "CB" is short for collective buffer. Members of the pension fund will still hold a personal account but will also have a claim on a collective buffer to smooth investment returns over time. In "good" years investment returns in excess of a certain threshold, say 10 pct. will be transferred from individual accounts to the collective buffer. In "bad" years, members will be compensated for very negative returns, say below -5 pct., by drawing from the collective buffer (if it is positive).

The buffer will be truly collective in the sense, that new members will get immediate access to the smoothing mechanism – even if they never contributed to it.

Conclusion

The Dutch pension system is trapped in a dilemma: Is pension insurance or investment? Until recently, Dutch pension funds delivered stable, real income streams to retirees. Pensions were delivered with an understanding of intergenerational solidarity which meant that working generations would absorb balance sheet volatility for the greater good and in confidence that, when they retired, future generations would do the same.

In this understanding, it didn't really matter whether pensions were insurance or not because *over a life-time everybody would get a fair deal*.

The Great Financial Crisis and societal change have changed that. The GFT pushed workers' willingness to contribute to the system to the limit, and the subsequent drop in interest rates demonstrated that insurance is very different from savings. Furthermore, labor market mobility challenges the level premium principle pushing for a more neutral system for the individual.

This has left Dutch pension funds close to – some even below – minimum funding levels leaving only hard choices.

In essence, Dutch pension funds are cooperatives: Members are customers as well as owners. But current legislation imposes tough capital requirements on pension

funds: Owners must suffer to protect customers – despite they are the same. Basically, regulation prevents pension funds from acting in their members’ best interest.

The effect of the reform will be to lift these restrictions: By allotting investment risk directly to the individual in the restated pension contract, capital restrictions will simply vanish. In the new system, pension funds therefore will act *on behalf* of members rather than *provide* members with a pension.

Technically, the new contract will allow for more individual choice in, say, contributions or investment profile. But it is hard to see how more options for choice could coexist with substantial risk-sharing in pension funds without introducing severe moral hazard in the system. A side-effect of reform therefore could be that the crown jewel of the current system, the cooperative nature of pensions, is at risk of being partly - or entirely - lost. Cooperative values have many names in the Dutch pension debate: solidarity, social contract, or intergenerational risk-sharing. All of which are rooted in Dutch culture and definition of welfare.

The reform will replace this incomplete *social* contract by a complete *financial* contract of individual accounts. In the new system, pension funds will be responsible for setting the rules - but they will no longer be held accountable for the actual (pension) outcome. In this sense, the reform is a massive transfer of risk from the cooperative to the individual. This is at odds with many values upon which the Dutch society is built. Are the Dutch prepared for that?

This is a reprint of the original report published October 2017.