A pension revolution in the Netherlands:

a new contract for different times

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'Just as there is a consensus that workplace pension systems around the world are sick, so are there strong views on what the cure is'[1], *quote from Keith P. Ambachtsheer*

This month trade union FNV approved the further implementation of the new Dutch pension deal. Trade union CNV had already approved the pension deal. On June 12th 2020, the details of the new Dutch pension deal were already finalized after tough negotiations. It took a long time before all complicated details could be determined concerning a modernized pension system for young and old, for retirees and near-retirees. These details concern the state pension and the collective pension plans of workers. Minister Koolmees of Social Affairs and Employment will discuss the outcome of the negotiations with the Dutch parliament this month. If the Dutch parliament also agrees, the new Pension Act has to be written in the next two years. A first pension agreement came in June 2019 after more than ten years of negotiations and occasional massive campaigning by union members. It is very complicated to create a new and fair pension system.

This article highlights some main points of the biggest Dutch pension reforms since 1954.

'Different times require a new contract'[2], *quote from Jan Tamerus*

Why change the best pension system in the world?

The Dutch pension system is recognized as one of the best in the world. This has been confirmed repeatedly in international comparisons by rating agencies of pension systems in a large number of developed countries. In hardly any other country poverty amongst older people is so low and the difference between disposable income before and after retirement so small.

The Dutch pension system has a strong base consisting of three pillars, each with their own features[3]:

[1] Pension Revolution: A Solution to the Pensions Crisis (2007, p. XXVII)
[2] Quote from Jan Tamerus, in: Defined ambition (2011, pag. 373)
[3] See: https://www.pensioenfederatie.nl/website/the-dutch-pension-system-highlights-and-characteristics

- *The first pillar is the General Old-Age Pensions Act (Aow): a basic provision instituted by the government in 1957 and paid to everyone living in the Netherlands, once they have reached the qualifying age. For decades, this age was 65 years, but it has been raised by several months a year during the last few years. People do not have to be in paid work to accrue Aow. The Aow should be seen as a basic provision at minimum level. The Aow is administered by the Ministry of Social Affairs and Employment and is funded from Aow-premiums and tax revenues, and not from capital paid in by the recipient: it is a pay-as-you-go system.*
- *The second pillar consists of the occupational pensions accrued by the vast majority of employees during their working lives (nearly 90%). Employees and employers pay the contribution agreed in collective employment agreements into a pension fund to which the employer is affiliated. This may be a pension fund for all businesses in a particular industry, a fund that works for one specific company, or a fund for a group of people working in certain (often medical) professions such as doctors, physiotherapists and obstetricians. The second pension pillar is an employment benefit. Participation has been made mandatory for most industry pension funds. Pension funds operate on the basis of capital funding: an employee, together with their employer, accrues pension entitlements from the contributions paid in and the return realized by the pension fund over the years through the collective investment of these contributions. The second pillar in the Dutch pension system features collectivity, mandatory participation, large scale administration and is not-for-profit (pension funds).*
- *The third pillar consists of individual banking or insurance products for which contributions can be paid in for accrual of a pension, with tax allowances up to a certain level. This is important mainly for those people who do not (or have not been able to) accrue a pension in the second pillar. For instance, because their employer is not affiliated to a pension fund, they are not in permanent employment or they are self-employed.*

Occupational pension schemes in the Netherlands are nowadays still mostly defined benefit (DB) schemes. But as companies are seeking to control costs and risk, a shift from average salary career plans is taking place. Also, the popularity of defined contribution (DC) is growing. Smaller companies often provide pension plans form insurance companies. This can be done by individual insurance contracts or by group insurance contracts. The tax treatment of contributions and benefits is the same as for pension funds.

Many challenges

The second pillar faces many challenges. Dutch people are, on average, living longer. Furthermore, the relative number of young people paying contributions is continuously declining. Moreover, interest rates are declining, funding ratios are low, the supervisory system is strict and there is a conservative discount rate for pension liabilities.

A well-known Dutch pension expert, Jan Tamerus, stated clearly in his PhD-thesis (2011*): 'Defined benefit is not sustainable. The unconditional nature of entitlements and a fixed pension age should be discarded'.*[4]

[4] P. 374, Defined ambition, Jan Tamerus, 2011.

Dutch central bank DNB: Many pension funds are struggling with financial deficits

The foundation of a pension provider requires permission from the De Nederlandsche Bank DNB. DNB acts as the supervisory authority for pension funds, and they mainly play a role in the second pillar. The aim of DNB is to safeguard the interests of all pension fund members. DNB monitors the following aspects[5]:

- Financial position: Do pension funds have a sound financial position and do they follow the statutory rules when increasing or decreasing pension benefits? A pension fund's funding ratio and the actuarial interest rate are important in this respect. Do pension funds have a sound investment strategy that is in the best interest of their members?
- Operational management: Do pension funds have their administration in order? Or do they have proper outsourcing arrangements in place with a third party?
- Board members: DNB assesses the fitness and propriety of pension funds' board members. They need our approval before they can be officially appointed as such.

Under the current Pensions Act and the Financial Supervision Act, the DNB closely monitors the financial and management operations of the pension providers. The legal FTK-framework (Financieel Toetsingskader) provides rules for the valuation of liabilities of pension funds. Underfunded plans are required achieve the minimum funding ratio within a certain time period to avoid the intervention of the DNB. DNB has recently stated that many pension funds are still struggling with financial deficits. The pension funds expect to eliminate those deficits by getting high returns on their investments. If the financial position of pension funds does not improve, 33 pension funds may need to implement a discount in 2021. At the same time, there are also 121 funds that can fully or partially index the pensions. These funds generally charge a higher premium, have more than average hedging against falling interest rates and invest less in shares.

Existing Dutch pension system up for change

The Dutch social partnership model gives trade unions and employers a decisive say in areas like pensions policy. The final agreement by the country's largest trade union FNV was reached on July 4th 2020. This month, the Dutch parliament will debate about the new pension deal. We expect that a new pension law will be designed by January 1st 2022. The new Dutch pension system will be introduced in 2026, or even earlier. It will happen in certain steps.

During the reform talks, the parties have agreed on the following issues.

- The state pension (Aow) age will rise less quickly than originally planned;
- There will be an early retirement option, aimed at people doing hard physical work;
- The reforms aim to spread the burden of paying for pensions more fairly across the generations.
- Everyone will pay the same pension premium (flat rate).
- All new pension plans will be (C)DC.

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[5] See: https://www.dnb.nl/en/about-dnb/dnb-pension-system/index.jsp

Can all pension cuts be avoided?

As part of the current pension agreement between the Dutch government and social partners, pension schemes with a funding ratio above 90 per cent will not have to cut payments in 2021. However, will this be enough to avoid all pension cuts?

The average policy funding ratio of Dutch pension funds fell further down from 98 per cent to 96 per cent in June 2020, according to Aon's latest Pension Thermometer figures. The policy funding ratio is based on the average coverage ratio of the past 12 months. Despite this decline, the figure is still above the adjusted temporary legally required minimum of 90 per cent. However, analysis by Aon of the large pension funds ABP, PFZW, PMT and PME shows that all currently have a policy funding ratio of below 90 per cent. Their policy funding ratios will decrease further when the higher funding ratio levels from before the coronavirus crisis are replaced with the lower levels of the crisis. Aon said the question is whether every pension fund will be above the 90 per cent limit before the end of the year. Aon believes there will still be a chance of limited discounts at the end of the year.

Main points of new pension deal

These are the main points of new pension deal:

- All (new) pension contracts will be (collective) defined contribution plans.
- All pensions premiums will be flat:
    - Stable, predictable, tax-maximized.
    - Age-independent premium.
- There will be a new collective pension plan (next to existing WVP-pension plan).

What are the characteristics of the new collective pension plan?

- A premium agreement, with personal pension pots and with a collective, solidarity reserve.
- All investments will continue to be managed collectively.
- Collective investing, but age-specific allocation of returns.
- Variable pension capital (moves with the financial market).
- Projection yield to facilitate a projection of members' "expected pension".

What is the solidarity reserve?

A solidarity reserve is a legally required intrinsic part of the new collective pension contract with extensive risk sharing. With the solidarity reserve, risks are shared in and between generations according to clear and balanced rules. Risks are shared with the aim of preventing bad luck and happiness generations. At the beginning, the solidarity reserve can be filled from the existing assets. Annually a maximum of 10% of the premium (active persons) and / or a maximum of 10% of the positive excess return (active people, sleepers and pensioners) are added to the solidarity reserve. The solidarity reserve may ultimately amount to a maximum of 15% of the total fund assets. With the solidarity reserve, windfalls and setbacks can be spread over time. The solidarity reserve cannot become negative.

In the new contract, a so-called ‘projected return’ will replace the current discount rate for liabilities which has significantly declined in the past years due to continuously falling interest rates.

The new concept of projected returns has several goals:

- to show scheme members their expected pension at retirement in a good, average and bad scenario;
- to determine the level of the pension after retirement; and
- to determine the necessary monthly pension contributions for members to achieve a pension of roughly 75% of the average salary after 40 years of service.

The new contract involves a maximum tax-facilitated contribution of 33% of pensionable salary.

Pension funds will in principle be allowed to determine their own ‘projected return’, and adjust it periodically depending on the investment results achieved, within certain boundaries to be set by pensions regulator De Nederlandsche Bank (DNB).

The new pension system requires adjustments in the investment strategy

Pension funds invest with the aim of ensuring that the contributions paid in by the participants today will provide a good income in retirement. The investment horizon is therefore extremely long. Dutch pension funds invest internationally in various types of investment that will continue to have value in the long term. The balance between return and risk is the central issue here.

The impact of this pension reform on the several investment strategies of Dutch pension funds is still under discussion. AXA Investment Management (Netherlands) believes the reforms will lead to €500bn of assets transferred from liability driven investments to cash flow driven investments. They believe that this pension reform is going to have a “profound impact” on the asset allocation of pension funds in the Netherlands and, more widely, the fixed-income market in Europe.

Achmea Investment Management also believes that the transition to a collective investment policy for individual pension pots and the abandonment of the (mandatory) nominal security will lead to adjustments in the investment strategy. How big and far-reaching these will be cannot be said yet with certainty. Achmea believes that much depends on the elaboration of the plans in the concrete pension plans. Tentatively, a number of conclusions are already emerging. According to Achmea these points are essential:

- Interest rate risk management remains important.
- The future investment mix can be filled in at a higher risk.
- Diversification remains an important cornerstone of investment policy.
- There remains room for illiquid investments.

At least the role of interest rate hedging is changing in the new pension contract, especially for longer terms. Pension funds will therefore adjust their interest rate hedge in the coming years.

Concluding remarks

The agreement that has been worked out has to ensure a sustainable pension system that:

- Offers a perspective for more purchasing power for pensioners, which also means that the pension more directly moves with the development of the economy and the financial markets.
- Makes pensions more transparent and personal.
- Better links up with developments in society and the labor market.

Is this a perfect agreement that will solve all pension problems? No, certainly not. However, trade unions are reasonable satisfied that mandatory collective pension schemes are still possible and that many collective elements are saved.

The large pension funds ABP, PFZW, PMT and PME, and the Federation of the Dutch Pension Funds are all enthusiastic about the new pension deal. Pension consultant Aon thinks the new contract is fairer and more transparent and calls the transition to a premium scheme a "historic fact in a pension country", in line with the statement by Piet Fortuin, chairman of CNV. Piet Fortuin called the Pension Agreement a "historic step forward". APG is also positive about the agreement: "The strengths of the old system will be retained".

Minister Koolmees of Social Affairs and Employment stated recently that he was very happy that the pension reforms will continue.

After 10 years of consultation, the big opportunity is finally here: the Netherlands can continue with the necessary pension reforms. It is a pension revolution for the Netherlands. Not perfect, but at least better than the current DB-pension system.

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