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PENSIONS WATCH – ISSUE 15: WHAT'S BEEN HAPPENING AND WHAT'S ON THE HORIZON IN THE WORLD OF PENSIONS

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In this edition of Pensions Watch, we consider the proposed reforms to one of the world's leading pension systems – that of the Netherlands. Crucially, we assess whether, post-reforms, the Netherlands can continue to set the bar for the three broad factors that determine pre-eminence in pension system design and if the reforms set a blueprint for other systems, facing the same challenges, to follow.[1]

A uniquely generous pension system

Despite the seismic demographic, economic and regulatory shifts that have challenged many other pension systems over the past couple of decades, the Netherlands' three-pillar pension system, introduced in the 1950s, remains uniquely generous in many respects, with collectivity and intergenerational risk sharing central to the system's ethos. Moreover, the Netherlands has long set the bar for the three broad factors that determine pre-eminence in pension system design: adequacy, sustainability and integrity (or security).[2]

Central to this pre-eminence has been the myriad reforms made, since the late-1990s, to the quasi-mandatory occupational pensions second-pillar, to deal with the unrelenting burden placed on defined benefit (DB) pension liabilities,[3] notably from increasing life expectancy and, most importantly, the structural decline in nominal and real interest rates, since exacerbated by the global pandemic. These reforms, notably the move, in 2004, from final salary to average pay DB contracts and the conditional indexation of benefits[4] which, along with subsequent policy changes, increased intergenerational risk sharing and have collectively served to evolve the second pillar.

However, notwithstanding these reforms, these and other challenges have combined to prevent most Dutch DB schemes from clawing back pre-global financial crisis regulatory coverage, or funding, ratios. Therefore, something more akin to a genuine revolution in pension scheme design – aimed at making the second pillar (almost) future-proof and to align with the growing individualisation of pensions flowing from changing lifecycle and career patterns – will soon become a reality.

Reshaping the second pillar

Indeed, after almost a decade of debate, it is envisaged that, from 2026, the end game will centre around two new contract options: the new pension contract (NPC) and the improved defined contribution plus (improved DC+) scheme. The former by far represents the biggest philosophical shift from the accepted norm, in that the long-held central principles of DB schemes combining a uniform contribution rate with a uniform accrual rate (or *uniformity pricing*) for all and guaranteeing the level of member benefits, will disappear. Rather, the NPC will convert all DB member accruals to a Collective Defined Contribution (CDC)-like system,[5] comprising an individual capital entitlement, or a *notional account*, within a single collective investment pool.[6]

[1] The full paper which supports this edition of Pensions Watch can be found at: https://www.columbiathreadneedle.co.uk/en/inst/insights/revolution-on-the-horizon-will-the-dutch-pension-system-still-set-the-bar-for-sustainability-adequacy-and-integrity/
[2] Mercer (2021), Mercer CFA Institute Global Pension Index. Available at: www.mercer.com/globalpensionindex. Please see Pensions Watch, issue 14, for what adequacy, sustainability and integrity comprise: https://www.columbiathreadneedle.co.uk/en/inst/insights/pensions-watch-issue-14/
[3] In the Netherlands, DB schemes are offered by around 90% of employers, via industry-wide and corporate plans, with near-universal employee coverage. In addition, about 10 professional group pension funds are made available to specific professions.
[4] Conditional indexation, is where pension entitlements pre- and post-retirement are revalued each year in line with price inflation or, to a lesser extent, the wage increase in the sector to which the scheme belongs, unless the financial position of the fund is judged by the pension fund board, against regulatory funding requirements, as being unable to provide indexation.
[5] Collective Defined Contribution (CDC) schemes set a target or "ambition" level of benefits to be paid as a pension for life with variable increases. Based on a fixed level of employer contributions, set for a fixed term of at least five years, after which they are reviewed, a CDC scheme, unlike DB, has the scope to redefine the benefits it offers if circumstances change, without the employer being required to pay shortfall contributions. As there is no sponsor covenant, there are no guarantees. So, whereas the amount of pension is based on salary and service years, just as it is for DB, if the fixed contribution rate and the investment returns prove to be insufficient to support this accrual, then the pension benefit will be necessarily lower than originally intended. However, by pooling money into a single fund, with a desired long-term asset mix, CDC pension arrangements allow employees to pool the risks of investing and longevity, achieve lower costs through economies of scale and permit greater and longer-term exposure to growth and illiquid assets.

Going forwards, *pension entitlements* will be replaced by *pension expectations*, more closely linked to contributions and financial market outcomes. Let me explain. An annual benefit, which can be adjusted up or down, will be allocated to the member's notional account throughout their lifetime, i.e. throughout both the accumulation and decumulation phases. That's the easy bit. The more complex part is that, based on a system of age-specific allocation of returns, these benefits will be determined by a combination of fixed contribution payments[7] and annual investment returns, adjusted for two factors. These comprise an actuarially-determined return or deduction, reflecting interest rate movements, and transfers to or from an investment *solidarity reserve*, which will seek to smooth the intergenerational effects of investment sequencing risk.[8] Capped at 15% of total fund assets, and unable to turn negative, this solidarity reserve will be funded by up to 10% of total contributions and 10% of "excess" investment returns, i.e. those generated above a defined threshold return. Of course, the rules of exactly how and when this reserve can be distributed among the membership will have to be transparently determined in advance. Indeed, from 2026, as part of a very transparent process, members should be able to compare projected returns by age cohort.

More evolution than revolution is the design of the improved DC+ scheme. This will replace the current, age-dependent, contribution structure within existing DC schemes, with a flat-rate contribution (though age-related contributions in existing DC schemes will continue) and the default of annuitisation at retirement with the continued investment of capital – though members can opt out of the latter if annuitisation is preferred. Of course, given the lower costs and governance requirements associated with DC, the improved DC+ scheme may well be an attractive alternative to the NPC for many corporate and smaller sector DB funds.

What are the likely asset allocation shifts from transitioning to the NPC?

The implications of moving to the NPC structure on pension fund investment will, undoubtedly, be acute, given the shift in focus from coverage, or funding, ratios to investment returns and from managing regulatory capital to managing economic capital. While diversification will remain integral to investment strategy, in all likelihood asset allocation will be shaped by three fundamental factors:

1. Given the age-specific allocation of returns, the emphasis will shift to creating investment strategies that take into account the risks associated with each age cohort.

2. Cash flow driven investment (CDI) is likely to take precedence over liability driven investment (LDI), resulting in some traditional hedging assets being sold in favour of shorter-dated credit, though interest rate hedging will remain a cornerstone of investment policy.

3. A longer investment timeframe should favour a greater allocation to risk assets and perhaps more illiquid investments, not least to private markets.

Although the exact size and timing of the resulting asset shifts are difficult to call at this early stage, especially against the backdrop of an ever greater focus on integrating Environmental, Social and Governance (ESG), particularly climate, risk factors into investment decision making, one thing is for sure, they will be seismic.

So can the Dutch pension system retain its pre-eminent position?

By moving from an average-pay DB to a CDC-like system, while the sustainability box is almost certainly ticked, adequacy and integrity could potentially be called into question. However, in making this assessment, there are two crucial, and somewhat comforting factors, to bear in mind:

1. Adequacy: The current pension benefits formula of *seeking* to achieve an income replacement ratio of 75% of the median wage for 40 years of contributions and 80% for 42 years will remain unchanged.

2. Integrity: Applying investment returns adjusted for interest rate movements and transfers to or from a solidarity reserve to individual notional capital accounts should ensure each member receives a fair asset share throughout the accruals and decumulation phases.

[6] By contrast, in the UK, DB benefits that have already been accrued are protected by legislation and cannot be changed retrospectively without member consent. Of course, those Dutch DB pension members disadvantaged by the reforms will need to be compensated, either by the pension plan or by the employer. This will prospectively take the form of either a payment or an additional, tax-incentivised, pension contribution, capped at 3% of the employee's pensionable earnings, for a 10-year period, ending in 2036 latest or when the employee changes jobs (with the new employer compensating them on the basis applied to its own workforce).
[7] Unlike CDC, these fixed contributions (which, over time, can be re-evaluated) won't be determined on the basis of a targeted or an "ambition" level of benefits – hence the reference to the NPC reforms being CDC-like.
[8] Investment sequencing risk is when the same stream of returns occur in a different chronological order leading to different outcomes.

Why does this matter?

Ultimately, this reform of the Dutch second pillar must be seen in the context of the need to future-proof the Dutch pension system against a world increasingly characterised by rapid economic and social change, shifting lifestyles and career patterns, overwhelmed public finances and the inability of the state to sustainably support structural demographic challenges. Indeed, as noted, these challenges have combined to prevent most Dutch DB schemes from achieving pre-global financial crisis regulatory coverage ratios.

When evaluated within this frame, despite the intergenerational compromises that may result from the reforms but with the principle of collectivity remaining intact, the Dutch pension system should retain its pre-eminence. However, agreeing the terms and the transition process won't be without its challenges.[9]

Crucially, those other pension systems facing exactly the same headwinds as the Netherlands, albeit with bigger adequacy and sustainability issues to resolve, would do well to observe the structure of these reforms and the process that's led to where the Dutch pension system is today. Indeed, all eyes will now be on the implementation of these reforms and the resultant outcomes. However, even before these reforms have fully played out, it would seem that the Dutch pension system will remain the poster child for sustainability, adequacy and integrity.

[9] In adopting the so-called social partnership model, these negotiations will be determined, in a tripartite fashion, by the Dutch government, unions and employers.

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