Revised Dutch pension crises prompt new proposal to modify the DC model

The Netherlands has long had a reputation for having a strong two-pillar retirement system that provides retirees with an income replacement rate of at least 80% per cent from the country’s national and occupational pension schemes. And until relatively recently, Dutch workers were equally as confident about their occupational plans as they were about the national pension system. Workplace pensions traditionally provided retirees with indexed payments, and the system was running smoothly until the information technology bubble popped and the market crashed in 2000, says Gerard Riemen, managing director of the Federation of the Dutch Pension Funds.

“You could say the dot-com crisis was kind of a wake-up call because it pointed out . . . the vulnerabilities of our pension system,” says Riemen, noting some pension funds had to skip a year or two of indexation to recover from the initial shock. Most pension funds recovered a few years later. In the meantime, the system underwent legislative changes to base benefits on retirees’ average salaries during their career instead of final earnings, says Riemen. The changes also meant indexation became conditional. “Almost everyone joined the pension schemes, so we thought it was fine, no troubles at all at the horizon and everybody was fine,” says Riemen.

The effect of the financial crisis on pension plans
But then the 2008 financial crisis hit and the country’s occupational pension funds once again found themselves in trouble, Riemen notes. “After that, the first thing that happened, of course, was our funding ratios went down and we had to skip indexations.”

“The market certainly had a significant impact on pension plans’ assets,” says Riemen. But over time, it became clear the fundamental problem was actually in the plans’ liabilities, which had a greater impact on funding ratios due to very low interest rates and longevity issues.

While those factors have burdened pension plans around the world, the repercussions weighed more heavily in the Netherlands because of how plans determined their valuation rates, says Barbara Sanders, an associate professor of statistics and actuarial science at Simon Fraser University in Vancouver. “In Canada, many of our plans are using what’s called a best-estimate valuation rate, so a valuation rate that is based on what you think the assets will earn, and that takes into account that if you’re invested in stocks, which you’re expecting to earn more from, then your pension fund can use a higher valuation rate that creates a lower liability,” says Sanders.

But in the Netherlands, pension plans have to adhere to a stricter framework, she adds. “They only use bond yields in figuring out what the valuation rates should be, so their rates are low compared to ours, so their liabilities are high compared to ours.”

Many plans have failed to meet the country’s strict solvency rules, says Riemen, noting the Netherlands’ pension legislation requires funding ratios of 125% to 150% per cent. “So the result was that funding ratios declined very quickly and for some pension funds in 2014, they even had to cut the benefits,” he says.

Despite a common belief in the pension guarantee, legislation actually allows the collective defined contribution plans that many workers are part of to cut benefits. According to Riemen, some plans were decreasing payments by as much as seven percent.

“While the measure wasn’t widespread, it was detrimental to the country’s pension system,” says Keith Ambachtsheer, director emeritus of the Canadian Aggregate Pension Management Institute. "Cutting pensions ruins the trust of the population in the pension system, and that’s what happened in the Netherlands: actual physical cuts where you tell pensioners we’re going to pay you less this year than we did last year, literally.”

But cutting benefits is the last resort for many pension plans, says Riemen, noting that when there’s a funding problem, plan sponsors can alternatively raise contributions or lower pension accrual rates for current employees. Some plans, however, had no room to increase contributions because they were already quite high, he adds, noting they instead decided to reduce pension accruals. The moves created tension among the generations because while current workers may make the same contributions as retirees did, their benefits may be lower when they retire, says Riemen.

Proposal for a new occupational pension scheme
In response to the issue, the Social and Economic Council of the Netherlands, which advises the government on social and economic policy, developed a new type of scheme called personal pensions with risk-sharing. The new model aims to replace the collective defined contribution plans that in many ways are similar to Canada’s framework for multi-employer pensions. It represents somewhat of a cross between the Netherlands’ collective model and individual defined contribution pension plans.

“The council said we should improve on individual defined contribution plans because with those plans, the employee bears the full investment and longevity risk. So let’s see whether we can pool (the risk) and still have individual pots,” says Fieke van der Lecq, professor of pension markets at Vrije Universiteit Amsterdam, a Dutch post-secondary institution.

She says the new pension design has both similarities to and differences from the current one. Under the new system, workers under collective agreements must participate in the plan and employers and employees continue to make contributions. Members also benefit from a life-cycling model in which their investments change over time, according to their age.

“Of course, when you’re young, you’re more in equities and when you’re old, you’re more in fixed income,” says van der Lecq, noting the approach differs from a pure defined contribution plan since, besides receiving annuity payments upon retirement, members benefit from having the rest of their savings invested through the collective arrangement.

The new system will address investment risks by allowing excess returns to flow into a buffer that acts as an emergency fund for plan members during times of very poor market performance, says van der Lecq. And it will try to tackle unexpected longevity increases by decreasing pension payments over a long period so that several generations share the burden.

As for individual longevity risk, van der Lecq says the system pools it into the plan, which is already a feature of the current collective defined contribution arrangement. “If you live shorter than expected, the remaining money stays in the pool for others who live longer than expected.”

Employee, employer and government representatives are currently reviewing the new scheme before the council makes a recommendation to the Dutch government, says van der Lecq.

But while personal pensions with risk-sharing are a good alternative because they bring many benefits, such as allowing employees to clearly see the accrual of their pension assets, transitioning to a new model won’t be easy, according to Riemen. “How do you make the shift from the current DB system to the new system?” he says. “How can you do that in a fair way so that nobody carries the burden for this transition period?”

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THE CHANGING FACE OF DUTCH PENSION PLANS

Besides the financial difficulties faced by Dutch pension funds, regulatory pressures have also been compelling the sector to consolidate over the years as larger plans absorb smaller ones, according to Simon Fraser University’s Barbara Sanders. Here’s a look at the changing face of supervised pension funds in the Netherlands:

<table>
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<th>Year</th>
<th>Compulsory industry-wide pension funds</th>
<th>Optional industry-wide pension funds</th>
<th>Company pension funds</th>
<th>Company savings funds</th>
<th>Occupational pension funds</th>
<th>Special legislation</th>
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Source: De Nederlandsche Bank