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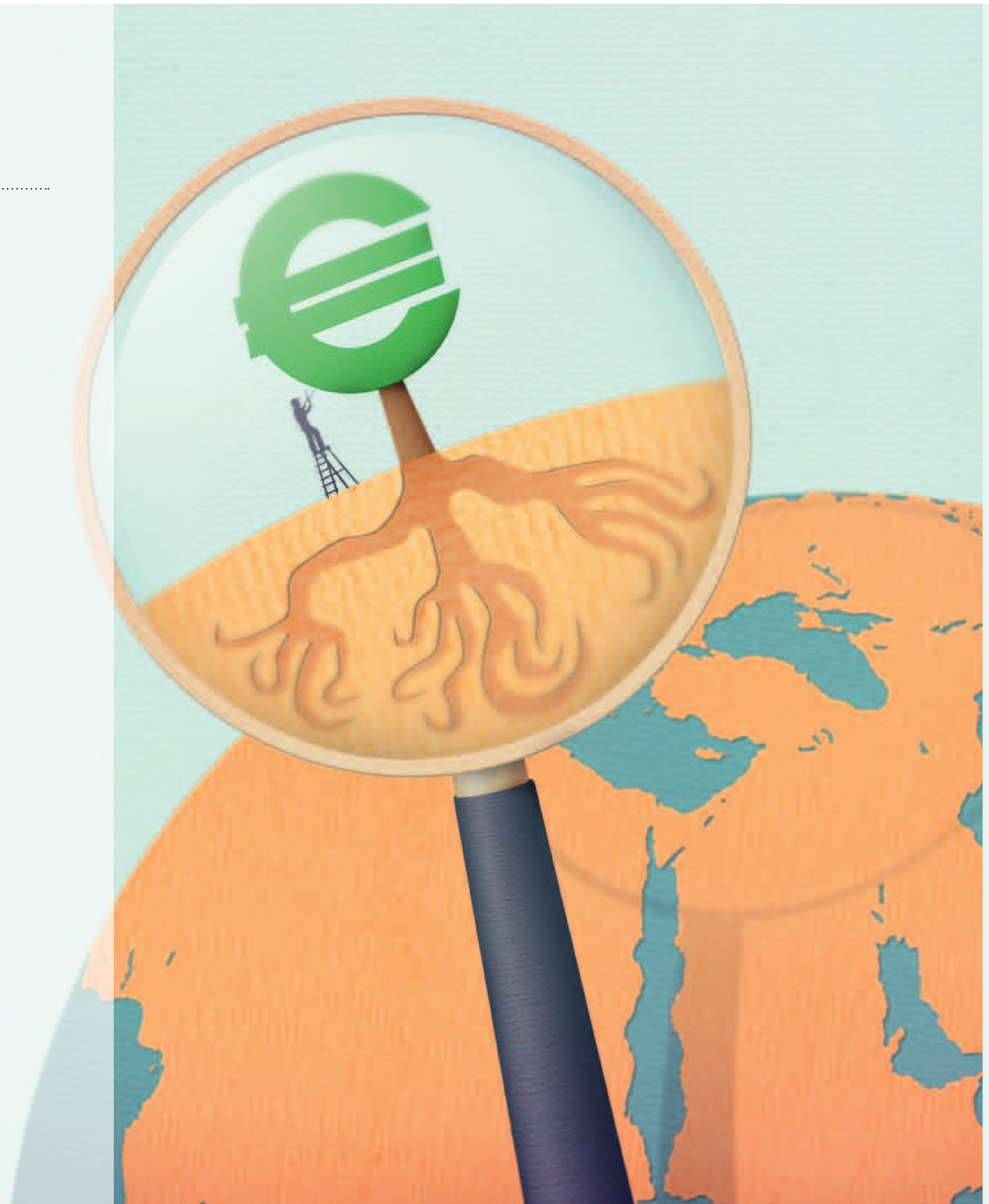
A view from the outside

on Dutch Pensions

The Dutch pension system is considered by many to be one of the greatest in the world. In the 2015 Melbourne Mercer Global Pension Index (MMGPI), the Netherlands was one of only two countries to receive the top available rating. The high level of pension assets present, excellent coverage of the population and good governance have all contributed to the robustness of the Dutch pension system. Ongoing reforms and the courage to make difficult changes to the system to keep it sustainable in light of demographic shifts have also contributed to its success. This paper outlines the areas of strength of the Dutch pension system, discusses some of the more recent changes to Dutch pension law, and highlights additional areas for improvement.



Background

The Netherlands has a multi-pillar pension system consisting of social security retirement benefits (pillar 1), company pension benefits (pillar 2) and private retirement savings (pillar 3).

Social security benefits are payable to all residents of the Netherlands, independent of how much they have contributed to the system over the years. The provision of such a minimum pension "safety net" ensures that all Dutch people will receive a minimum level of benefits in retirement, at least enough to be able to hopefully live out their lives in dignity.

As Social Security benefits are only intended to provide a minimum pension to all residents, most employers in the Netherlands also provide company pension benefits to their employees. Common plan designs and structures include defined benefit (DB) foundations, defined contribution (DC) foundations, insured DC plans, industry wide multi-employer plans, and a special Dutch invention, the Collective DC or CDC plan.

In a CDC plan, the pension scheme will target a benefit level, based upon an agreed set of assumptions, such as life-expectancy, investment returns, etc. However, if these assumptions are not borne out in practice, the benefits will ultimately be reduced. One could argue that this type of plan design combines many of the positive attributes of both a DB and a DC plan; it gives beneficiaries the ability to plan for their retirement based on clear expectations, while the employer does not bear the risk of adverse deviations to expectations and does not need to show liabilities in its balance sheet, as it would have to in the case of a DB plan.

Properties of an "Ideal Retirement System" and a comparison of the Dutch retirement system with these characteristics

All developed western nations are struggling with the same issues: Low economic growth, low birth rates, societies that are growing older and pension systems that are in many cases insufficiently robust to deal with the economic and demographic challenges they will have to face in the coming years. So how should modern retirement systems be structured in order to best deal with these challenges?

Mercer, together with the CFA-Institute, prepared a study in 2015 entitled "Ideal Retirement Systems." A key purpose of this study was to analyse the characteristics of effective retirement systems and to identify best practice.

Among others, the following characteristics of an ideal retirement system were identified:

1. High coverage within the private pension system
2. Mandatory contributions of at least 8% of earnings
3. 65 – 80% target net replacement rate for average earners
4. Funded assets for the future of >100% of the country's GDP
5. A basic pension for the poor of at least 25% of average earnings

Given the Netherland's top rating in the Mercer Melbourne Global Pension Index, it is not surprising to find that the Dutch pension system performs well against each of these five criteria:

1. High coverage within the private pension system: The level of coverage of retirement benefits in the Netherlands is one of the highest in the world, with 88% of workers covered by a private second pillar pension scheme (Source: Ideal Retirement Systems Research).

2. Mandatory contributions of at least 8% of earnings: According to the MMGPI research, the average mandatory contribution to a funded pension plan in the Netherlands is approximately 8%, thus meeting the criteria set out for an Ideal Retirement System.

3. 65 – 80% target net replacement rate for average earners: The OECD publishes a report on pensions at regular intervals entitled "Pensions at a Glance", in which pension systems in the OECD countries are compared and contrasted. According to the latest OECD study, a median earner in the Netherlands will receive a net replacement rate at retirement of just over 100%, again making it one of the highest in Western Europe. To contrast this, in neighbouring Germany, a median earner will generally not attain the 65% net replacement rate target, and the UK comes in at roughly only 69%. Thus while most developed societies worry about large groups of pensioners who cannot afford to retire, or who at the very least are unable to maintain their lifestyle once they do retire, this problem is considerably less prevalent in the Netherlands.

4. Funded assets for the future of >100% of the country's GDP: One aspect that is examined in the MMGPI is to what extent assets have been set aside in order to pre-fund future pension obligations. According to the 2015 Global Pension Index, there were pension assets in the Netherlands of approximately 160% of GDP. This high level of funding helps ensure that the intergenerational contract is adhered to. Other countries that rely more heavily on pay as you go financing may be in for a rude awakening as they find their populations aging, leaving an ever shrinking active population to pay for the benefits of an ever growing pensioner population, making their pension systems potentially unsustainable in the long run.

5. A basic pension for the poor of at least 25% of average earnings: The Dutch social security program provides a minimum pension at retirement, based on residency. For a married couple, each person would receive 9,481 EUR per year, for a single person the amount is 13,866 EUR (2015 figures). According to the Ideal Retirement Systems Research, the basic pension for a single low income pensioner in the Netherlands is approximately 30% of final earnings, making it one of the highest minimum pension benefits for citizens in Western Europe. Unlike some of its neighbours who do not have a minimum pension, the provision of a basic pension will help to ensure that old-age poverty will not be a wide-spread phenomenon in the Netherlands, as it otherwise would be.

Dutch pension reform: Ensuring sustainability for many years to come

Part of the reason the Dutch pension system is one of the most robust in the world is the fact the government of the Netherlands has had the courage to make reforms to the system as necessary.

The reforms in the first pillar, the pay as you go social security system, were relatively straightforward to implement. To ensure the sustainably of the system, the normal retirement age is in the process of being increased in stages from age 65 to age 67 in 2021. From 2021, the normal retirement age will be increased automatically based on improvements in life expectancy. Given that roughly half of the total retirement income benefits paid in the Netherlands come from the first pillar, these reforms will help to ensure that all citizens can expect to receive a reasonable basic pension from social security, for many years and hopefully generations to come.

Second pillar pensions, company sponsored pension benefits, account for roughly 40% of retirement income in the Netherlands. Benefits under this pillar are financed by employers and employees, with the government's role being that of a supervisor and facilitator. Making reforms to second pillar benefits has historically been less straightforward, and more controversial than making reforms to first pillar pensions.

Given that it is so often praised by those living outside of the Netherlands, it may come as a surprise to hear that many Dutch people are not happy with their second pillar pension system. In order to put this mistrust and discontent in context, one needs to realize that the Netherlands was traditionally a DB-pension market, in which for many years everything seemed to be working well. Thanks to an extended period of asset growth in the 1980s, 1990s and early 2000s, pension plans were generally well funded and were consistently able to provide voluntary features such as conditional indexing of pensions in payment. However, the financial crisis in 2008 introduced a new and challenging era for Dutch second pillar pensions. Suddenly little or no indexation of pension benefits was being granted, and some pension funds even needed to reduce the benefit entitlements of plan members. These events have led many people to lose trust in the system, and the perception of the second pillar has become generally speaking quite negative; even though by all objective criteria, such as outlined in the Ideal Retirement Systems research, the Dutch pension system on the whole remains one of the best in the world, even today.

There is much ongoing discussion amongst employer and employee organizations and other stakeholders about possible reforms to the second pillar pension system. Two new key publications which set out the future expected course for the second pillar were published in July 2015, the "Act on Variable Pension Payment" and the "Guidelines for a Future-Proof Pension Scheme." The former is a law which for the first time permits retirees from defined contribution

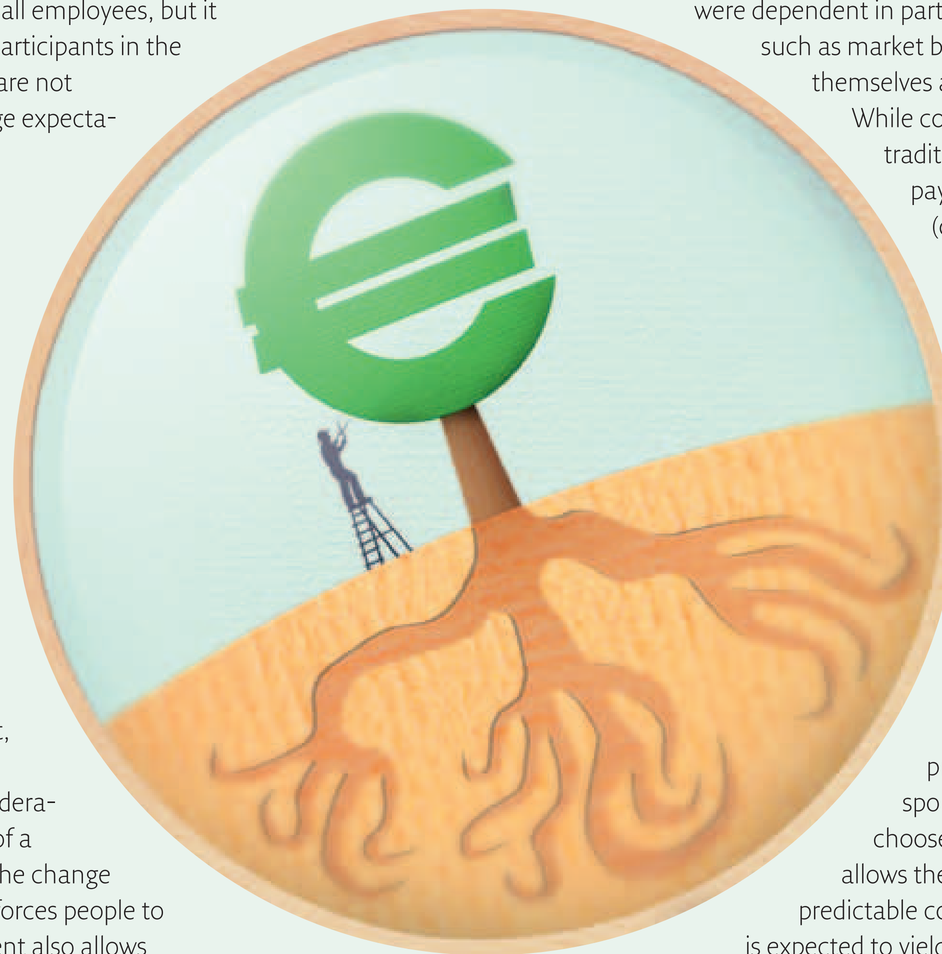
pension plans to stay (partly) invested in their retirement accounts, allowing them to maintain exposure to higher yielding asset classes, rather than being forced to purchase a life-long annuity at retirement. The latter is a discussion paper from the pensions minister, seeking commentary from the industry on the future of second pillar pension benefits in the Netherlands.

While many of the details still need to be agreed upon and the full practical implications of new legislation is not yet known, the suggested changes to be made to the system over the coming years are expected to be comprehensive. Two areas where there may be opportunities under the new second pillar pension regime are as follows:

1. "Removal" of (perceived) guaranteed benefits
Under the current approach for defined benefit pension plans, actuarial forecasts are used to determine what contributions need to be made and what benefits can ultimately be paid. If the assumptions used in these forecasts do not bear out in practice, in a negative scenario sponsoring companies of DB plans will generally either have to make additional one-time contributions to the pension funds to make up the shortfall in funding, or increase premiums, or both. Unfortunately, such cash-calls from the pension funds typically occur at the worst possible time for sponsoring companies and employees; a general economic downturn will often cause pension assets to decline at precisely the same time as many companies are suffering economically, thus making it more difficult to make additional contributions to their pension plans. The only tools available to the pension funds to deal with such situations at the time being are to increase required contributions, to cut pension indexation benefits, or to reduce the benefits in extreme cases. Regrettably, under the current market conditions, more and more pension funds find that they are forced to go this route, and many employees who mistakenly thought that their benefits were guaranteed are shocked and dismayed to find them being reduced. To maintain faith in the pension system, it is important to create a framework where participants realize that the growth of pension assets is a major factor that will drive the level of their future pension benefits, and that if growth does not happen as expected, their benefits may need to be adjusted.

Mercer has come up with a unique and creative plan design, which we believe will work well under the new framework:

- All employees participate in a pension plan that has a material amount of exposure to growth asset classes; this will ensure that the expected pensions at retirement are higher than they would be if a more conservative investment strategy were to be used. Projections of future benefits should be provided to all employees, but it needs to be made clear to all participants in the communication that benefits are not guaranteed, in order to manage expectations and to avoid surprises.
- Beginning at a certain age (perhaps around 50 or 55), the asset performance could be smoothed over a period of perhaps 10 years. Thus if there is a year with poor asset performance, where for instance 10% of the pension assets are lost, this would only impact the benefit for someone one year before retirement by 1% instead of 10%. This would allow participants to maintain exposure to growth assets right up until retirement, which increases the expected return on pension assets considerably as compared with the use of a life-cycle investment model. The change in legislation which no longer forces people to purchase annuities at retirement also allows exposure to growth assets even beyond retirement, which further increases the expected asset returns to plan beneficiaries. If there is an extended period of negative returns, then these would need to be socialized amongst the group of "older employees" for which the smoothing applies, ultimately leading to a material reduction in benefits for this group. This being the case, even in the "worst-case" scenario, the reductions will not come as a surprise, and in the long run, we expect more people to be better off under this type of approach when compared with a more traditional investment approach.



2. Pensions contributions to be fixed at a prudent level
Pensions represent a long-term financial commitment. The contributions that would need to be made over the course of someone's career in order to finance a given pension benefit are uncertain and are dependent on a large number of factors, one of the most critical being the return on the underlying assets. Historically, company contributions to DB pension schemes were quite volatile, as they were dependent in part on external factors such as market bond yields, which themselves are inherently volatile. While companies were traditionally quite happy to pay lower contributions (or even take a contribution holiday) in periods where expectations were exceeded, many found that the requirement to pay more than expected when performance goals were not met put them under immense strain. In light of this, it may be prudent for plan sponsors in the future to choose a plan design which allows them to set a stable and predictable contribution level which is expected to yield adequate benefits over an individual's career, such as 10% of salary, instead of having to base their funding requirements on highly volatile long-term financial projections, as is often currently the case. Doing so would ensure that employers would have a predictable and thus manageable pension expense each year and not result in an unfortunate asymmetric result. We currently see that companies are allowed to make smaller contributions when the markets are performing well, but are required to make larger contributions during periods of economic downturn.

While we expect that the changes in pension law will help to bring about a greater degree of stability to the Dutch pension system, the positive attributes of the current pension regime, such as cost effectiveness and mandatory participation, should be maintained.

Additional areas for improvement

Although the Dutch pension system is one of the best in the world, there are still some areas for improvement. One area in particular is the level of labour force participation for older workers: Encouraging people to work longer would have the compounding effect of giving the individuals more years to accrue a pension, as well as less years of expected retirement during which they would need to live off of their pension savings. Extending an individual's working life by a relatively short period can, through these compounding effects, have a large impact on the monthly pension amounts that the individual would ultimately receive once they retire. Increasing the state retirement age even modestly can also produce material cost relief for the country, for the same reasons.

Conclusions

The Dutch pension system has consistently faired very well when compared with the pension systems in other countries. Nevertheless, the Dutch second pillar system is not immune to the problems facing pension systems in other geographies, such as an aging population and the low interest rate environment. By maintaining the positive characteristics of the system, such as broad-based coverage through mandatory participation, while making changes such as the removal of guarantees and volatile contribution schedules, the pension system will hopefully remain sufficiently robust to stand the test of time and provide an adequate retirement income for many generations to come.