CHRIS CURRY
Director of the Pensions Policy Institute (PPI)

View from the UK

Pensions have been reformed extensively in the UK in recent years, and the Dutch system is often used as example of what the UK should be aiming for. But is there anything that the Dutch pension system could learn from the UK reforms?

The UK pension system seems to be in a state of constant change. Since the final report of the Pensions Commission in 2005[1] that highlighted many of the shortcomings in UK pensions there have been a series of reforms that have affected every aspect of both pension saving and state pensions. On the state side, a new State Pension has been introduced for those reaching State Pension Age from April 2016, with the intention of eventually paying nearly all retirees the same flat rate state pension (although as with most UK pension reform there is a long transitional period before the desired outcomes happen in practice). State Pension Ages are steadily increasing, and an independent review which concludes in 2017 is likely to recommend further rises in future.

In private pensions, the changes have been even more dramatic. Since 2012, employers have begun to automatically enrol all qualifying workers[2] into a workplace pension scheme, significantly increasing the number of people contributing to a workplace pension – an additional 6 million by March 2016,[3] expected to eventually increase to 9 million.[4]

In March 2014, another major reform was announced. From April 2015, individuals with Defined Contribution schemes have much more freedom and choice as to how they use their pension funds. Whereas historically individuals have had to use at least 75% of such funds to purchase an annuity (a guaranteed income for life), they now have complete flexibility as to how they take their funds (once they have reached the minimum withdrawal age of 55) and what they then do with it.

And further changes are expected. The Government recently consulted on changes to the way in which pension savings are taxed (contributions are currently exempt from income tax, investment is broadly tax free but most pension withdrawals are taxed). Although no changes have been made yet, the introduction of lifetime savings products (with penalties for withdrawals other than for a first house purchase before age 60) with a different but just as generous tax treatment (contributions are made from taxed income but with a 25% bonus given, then investment returns and withdrawals are tax free) suggests that some proposals are still under consideration.

With all of these major changes occurring almost simultaneously, you might think that the UK has now sorted out its pension system, and is looking forward to a period of relative stability. But far from it. And this is where I think international observers – including the Netherlands – can learn some useful lessons.

Pension reform takes time

The first important lesson is that pension reform takes time. The Pensions Commission first recommended automatic enrolment into workplace pensions in 2005. The process began in 2012. Because of the way it is being introduced to the largest employers before the smallest, and contributions being introduced at a low level before increasing to the agreed minimum level, it won't be until April 2019 that the policy is finally fully in place – almost a decade and a half later. So if the Netherlands is facing similar problems to those identified in the UK related to higher life expectancy and lower expected investment returns leading to higher costs, starting to deal with the issues sooner rather than later could make any reform less severe than it might otherwise need to be.

The next lesson from the UK is that reforms can be easier to implement where there is a degree of consensus around what needs to be done. A good example of this is automatic enrolment, which had a very high degree of consensus not only across political boundaries, but also with employers and representatives of employees (such as charities and trades unions). This has meant that there is still widespread support for the principle of automatic enrolment despite the lengthy introduction period and the changes in the economic climate that have happened since the idea was first proposed.

There is, at the moment, less consensus around some of the other changes in private pensions, such as freedom and choice in DC pensions, which were introduced much more quickly and without prior consultation. Consequently, there is still a lot of uncertainty as to how people will respond to the changes, and what the implications might be for long term levels of pensioner income, and potentially Government expenditure. In the short term the Government might benefit by collecting more income tax as individuals withdraw money from their pensions more quickly than before, but in the longer term if people run out of money they may fall further back onto state support. Consensus doesn't, however, guarantee that things will always work smoothly. Even though there is widespread support for automatic enrolment, the original idea has led to much wider reform than originally envisaged. Part of this can be ascribed to another lesson – know what you are ultimately trying to achieve. The concept of auto-enrolling workers into schemes has been accepted, but it soon became clear that it might not make sense to enrol people into schemes that were not good quality – with good quality meaning well administered, well governed and without excessive charges. So it is important to look beyond the tools you are planning to use to see what the outcomes are that you would view as successful. In the UK, there have been numerous attempts to improve regulation, increase standards and lower costs – in fact even to discover what the costs are – that are still going on even though people are now being placed into schemes. While it was originally thought there might be a handful of large multi-employer mastertrust schemes entering the market to provide schemes for smaller employers, over 100 have entered and there are concerns that not all of these will be viable in the long-term, or provide good outcomes for members.[5] But this is where the Netherlands already has a comparative advantage. The very characteristics that the UK are trying to build into the pension system, such as economies of scale, and efficiencies and transparency of investment costs, are strengths of the Dutch system. So the next lesson is build on what you have that already works well.

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Scale and transparency are just 2 of the areas in which the UK has looked to the Netherlands for examples of best practice. A number of UK reports have suggested that the way in which the investment industry operates in the Netherlands has significant advantages over the UK,[6] not least in terms of the efficiency and low cost arising from investing with scale. And while the UK has placed a charge cap on costs for the funds used as default investments for automatic enrolment, the Government is still struggling to even identify the levels of costs involved with running and investing pension scheme assets. The Netherlands appears to be leading the way in transparency too.

The other area where the UK has been looking to the Netherlands – although not as yet following their example

– is in the allocation of risk between pension sponsors and scheme members. In the UK there has been a straightforward move away from Defined Benefit schemes – with the majority of risks being taken by the scheme sponsor – to Defined Contribution schemes with the risks being faced by the scheme member. This has led to some concern that the scheme members who do not understand, for example, investment, inflation and longevity risk, will be unable to adequately manage their income and assets throughout their retirement (perhaps not universal concern however, as the introduction of more freedom and choice at retirement has increased the exposure to these risks).

The UK Government was so concerned that it began to introduce legislation to allow for different types of "risk sharing" pension schemes to be developed, which could allocate risks either between the scheme sponsor and the member, or between different groups of members, in ways between the extremes of Defined Benefit and Defined Contribution. Recent developments in the Netherlands – such as the use of conditional indexation - were used as examples of how this might work in practice.

The UK Government commissioned the PPI[7] to look at how some of these schemes, and in particular Collective Defined Contribution (CDC) schemes, might improve member outcomes compared to the traditional Defined Contribution (DC) approaches used in the UK – individual accounts, life styled and then used to purchase a lifetime annuity from a provider. There were some interesting findings.

In the long term, once the scheme is mature and the scheme population is stable, the CDC schemes modelled (with a 10% contribution rate) produced better outcomes than the traditional DC scheme based on the same contribution and used to purchase an annuity – providing a replacement rate (of pension compared to earnings) of between 27% and 30% in CDC compared to between 12% and 21% in DC. However, these results were heavily driven by the assumption of scale, and assuming that there was an element of pre-funding in the CDC schemes (so they start off well-funded). And the traditional DC results were lowered by the requirement to purchase an annuity in the market place (with associated costs for risk management and assumed lower investment returns compared to a CDC scheme where the annuity is paid from the scheme that can remain invested on a collective basis).

But even without these advantages, the CDC scheme performed as well as the best perform DC alternative, was less likely to run out of money, and had a more certain, narrower range of outcomes.

Although this research was narrowly defined, and set very much in UK context, it does highlight one of the current strengths of the Dutch pension system, the ability to share risks. This is not painless, and does not always work well if it is not well defined or well understood, but from an individual perspective might be preferable to the uncertainty offered by pure DC arrangements.

But even with these findings, the legislation needed to put these schemes into practise has stopped, with no sign of starting again. Why? A lack of demand from scheme sponsors, who at the moment seem broadly happy to offer DC schemes with no (obvious) risk to themselves (there may well be reputational risk, and difficulties in managing an increasingly elderly workforce if the pensions perform badly). And no real demand from providers to be able to set up the schemes either – linked of course to the lack of demand. Once the system has moved to DC, it is hard to move it back.

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You may have noticed that in the PPI research looking at CDC schemes, the contribution rate was set at 10%, and the resulting replacement rates were still pretty low. That is not at all unusual for DC in the UK, and is in fact above the minimum default contribution required (which will undoubtedly become the most common).[8] This is another area in which the Dutch system starts from a position of strength. Not only are contributions considerably higher in the Netherlands, there is (or so it appears to the UK) little concern that these contributions are not affordable. Whereas in the UK we have had to introduce a system based on inertia so that many people will not even realise they are saving into a pension scheme, the Netherlands population appears to have a savings culture based around agreement from the Government, employers and employees. Perhaps the greatest challenge facing the UK system is how to increase contribution levels. The Netherlands does not have the same problem – and this is a real advantage.

So, what can the Dutch learn from a view from the UK? Firstly, hang on to the strengths in the system – scale, transparency, efficiency, and buy-in from the members. Secondly, if risks need to be reallocated (typically towards members), make sure those bearing the risks are aware of them, can manage them, or have them managed on their behalf (for example through defaults). If you are starting on a journey of reforms, know where it is you want to go – in terms of what the system should deliver – from the outset. Get as much consensus as is possible along the way – if everyone is on the journey together, and you all know where you are going, there is more chance you will arrive. And finally, be aware that once you have started, it can be very difficult to go back to where you started. Once sponsors have shed risk, they can be loathe to take it back.

Chris Curry is the Director of the Pensions Policy Institute, an independent research institute with no political affiliation specialising in research into UK retirement issues.

Perhaps the greatest challenge facing the UK system is how to increase contribution levels

1. The Pensions Commission (2005) A New Pension Settlement for the Twenty-First Century: The Second Report of the Pensions Commission
2. Generally employees aged between 22 and state pension age, earning more than £10,000 per year
3. The Pensions Regulator (2016) Automatic enrolment Declaration of compliance report July 2012 – end March 2016
4. DWP (2015) Millions more saving due to automatic enrolment, Government Press Release
5. Pensions Policy Institute (2015) Comparison of the regulatory frameworks for DC pensions
6. See for example Pitt-Watson, D. (2013) Collective Pensions in the UK II: Now is the time to act
7. Pensions Policy Institute (2015) Modelling Collective Defined Contribution Schemes
8. Currently automatically enrolled individuals must contribute a minimum of 2% of earnings between £5,824 and £43,000, of which at least 1% must be an employer contribution. By April 2019 this will rise to 8% of earnings in this band, of which at least 3% must come from the employer.