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Risk Sharing Pension Plans: The Dutch Experience

Summary

This technical briefing note draws on the experience of running "Defined Ambition" style pension plans in the Netherlands. Since the early 2000s, the Dutch pension system has seen a shift away from Defined Benefit (DB) pension plans based on a final salary structure in favour of career average structures where annual indexation is subject to the levels of funding within the plan, and where benefits may be reduced if necessary in order to agree a recovery plan.

However, since the Global Financial Crisis in 2008 and the associated low interest rates and funding deficits that arose (see pages 4-6), there has been a lively national debate in the Netherlands around the long-term sustainability of these collective plans and, linked to that, the transparency of the existing contractual arrangements and members' individual property rights.

The mandatory participation in occupational or "second-tier" pensions in the Netherlands, along with a highly unionised collective bargaining environment, create some important distinctions between the workplace pensions landscape in the Netherlands and the UK. The Dutch pension system has been built on principles of collectivism and solidarity, while the UK system has increasingly been moving towards greater individualisation, particularly with the rising popularity of Defined Contribution (DC) pensions with employers since the early 2000s and, more recently, the Budget 2014 changes to how DC pension savings can be accessed at retirement. These experiences may affect the attitudes to benefit security and appetites for risk across the two countries, with the Dutch system developed from DB plans with a history of high benefit security compared to the DC plans that are now more prevalent in the UK. The two systems may move closer together in future, with the debate in the Netherlands increasingly focusing on the issues of freedom and choice (see pages 12-13), and with the UK Government introducing enabling legislation to encourage the development of risk-sharing and collective benefit designs.

The recent experience of the Netherlands offers lessons for plans with similar risk-sharing or collective elements that could be established in the UK (see pages 13-14), including:

- The need for contractual agreements and members' expectations to be fully aligned from the outset, and for there to be explicit communications about the potential risks to members future indexation and benefits and the measures that will be taken by trustees (or by other decision makers) to address any changes in the funding position;
- The need for clearly-defined individual property rights at fair market prices in a pensions landscape without mandation and with freedoms for members to stop their contributions, withdraw at retirement, or exit the plan altogether;
- The collective 'benefits' of scale that can also be delivered through DB and DC schemes, even in the absence of collective risk sharing or pooling;
- The potential for innovative ways of pooling individual longevity risk for the in-retirement benefits for plans, either in a fully collective plan, or in a plan which is DC in the accumulation phase but has collective elements in retirement.

Introduction

The Government is introducing new legislation to facilitate the development of **shared risk schemes and collective benefits** in the UK. This legislation was introduced to Parliament on 26 June 2014 following extensive joint-working with the industry, discussion with consumer representatives and two consultations by the Department for Work and Pensions (DWP), with the intention for the Bill to receive royal assent before the end of the current Parliament.

The Bill defines three categories of pension scheme based on the type of promise, i.e. the certainty, offered to members during the accumulation phase about the level or amount of their pension benefits when they come to access them. This promise will either refer to all of the retirement income payable from the scheme (defined benefits), some of the income

PPI Briefing Notes clarify topical issues in pensions policy.

or some or all of the pot (shared risk), or there will be no promise (defined contribution). The Bill also includes measures to enable the provision of collective benefits. Collective benefits are provided on the basis of allowing the scheme assets to be used in a way that pools risks across the scheme membership.

Some forms of risk-sharing schemes do already exist in the UK, for example, hybrid schemes including cash-balance schemes, and with-profit arrangements. The proposed legislation also allows for the development of new structures offering collective benefits that allow for the pooling of investment, inflation and longevity risks between members within a workplace pension structure, and allows for pensions in payment to fluctuate. These schemes do however already exist, or are in development, in a number of other countries, including the Netherlands, Nordic countries and Canada.

This briefing note is the second of two technical briefing notes and focuses on the Dutch experience of setting up risk-sharing plans. The first briefing note focused on the experience in Canada.[1] For clarification, this briefing note will primarily focus on the collective benefit features that exist within the Dutch plans, though it should be noted that in many of these plans it is still possible for employers to make additional contributions, for example to improve the funding position of the plans. The overall level of contributions (including any additional recovery contributions) are typically negotiated on a rolling basis e.g. every 5 years between trade unions and employers organisations (known in the Netherlands as the "social partners"). The Dutch collective plans are classified as DC for accounting purposes but are still treated as DB by the DNB (the Dutch pensions regulator) when assessing their funding positions and from a tax treatment perspective.

The landscape for pension provision in the Netherlands

The Dutch pension system is characterised by three pillars. The first pillar is the state pension, known as the "AOW", which provides a flat-rate basic retirement income, linked to the statutory minimum wage of €17,830 in 2014. Single pensioners receive 70% of the minimum wage and couples each receive 50%. Those living or working in the Netherlands build up entitlement to 2% of the state pension benefit for each year they are insured within the system, so between the ages of 15-65 they can build up full entitlement. As in the UK, the Dutch state pension is funded on a pay-as-you go basis with those of working age funding the benefits of current pensioners. The state pension age is being gradually increased to 66 in 2019 and 67 in 2023. From 2024 onwards, the AOW pension age will be linked to life expectancy. In addition, during negotiations for a coalition government the respective parties agreed on faster increases in the AOW pension age. These proposals are still being debated in the Dutch parliament.[2]

The second pillar then consists of occupational pension schemes, strictly separated from the employer, which are either administered by a pension fund or by an insurance company. Pension funds are divided broadly into three groups:

- Industry-wide pension funds for a whole sector (73 funds in total, with 5.04m active members, according to DNB statistics) - for example ABP, for the civil service, PMT, for metal workers and mechanical engineers, and PFZW, for the healthcare sector;
- Corporate pension funds for a single company but arranged through a corporation or insurer (274 funds in total, with 630k active members) - for example the pension funds run by Akzo Nobel, ING, Phillips, Shell, and;
- Pension funds for independent professionals (11 funds in total, with 50k active members) - for example, SPH, the fund for General Practitioners, and SPT, the fund for Dentists.

The second pillar is funded, and is comprised of a mix of DB, CDC (typically career average) and DC pension arrangements.

The second pillar plays a very significant role in the Dutch pensions landscape, driven by

Chart 1: mandatory participation in Dutch pension plans (Chen and Beetsma, 2013)

- **Large mandatory participation ("Grote Verplichstelling") or Big obligation** – upon request from the social partners, the Minister of Social Affairs can make participation in a pension fund mandatory for all employers in a sector or profession.
- **Small mandatory participation ("Kleine Verplichstelling") or Small obligation** – participation in the pension arrangement provided by their employer is mandatory for employees.

- Employers may be **exempted** from participation in a fund if one of the following conditions is met:
  i) the employer already provided a pension plan for at least six months before it became obliged to join the fund;
  ii) the employer has another collective agreement with the social partners; or
  iii) the sectoral pension fund has been underperforming for at least the past five years.

the principles of intergenerational solidarity and mandation within the occupational sector and the high levels of contributions. In the Netherlands, if an industry-wide pension scheme is set up by the social partners, it then becomes mandatory for the entire sector or profession under the "Grote Verplichtstelling" (see Chart 1).[3] This explains the very high pension coverage seen in the Netherlands, with over 90% of employees currently participating in a plan.

Mandatory participation helps to overcome the problem of myopia (or short-sightedness) where individuals do not save enough for their retirement. It also facilitates lower costs by reducing distribution and marketing costs for the pension funds. It also enables risk-sharing between different cohorts, for example by preventing younger cohorts from refusing to join, or being able to leave, the pension funds if they are in a position of underfunding.

Employers for whom there is not a mandatory scheme in place can choose to either set up their own corporate pension fund or offer a pension scheme managed by an insurance company. In some cases employers can also opt out of the industry-wide pension scheme but only if they have dispensation to do so from the trustee board.

The third pillar is comprised of individually arranged private pension products, primarily used by the self-employed and employees in sectors where there is not an industry-wide arrangement. It may also be used by those with second pillar pensions to top up their retirement savings and maximise their available tax-favoured benefits.

One important feature of the Dutch pensions landscape is the tax treatment of private pension savings. The system was established around the DB model,

where each individual has a maximum annual accrual rate that is tax favoured (the Dutch pensions tax relief is broadly an 'EET' structure, as in the UK). This uniform annual accrual rate (known as the "doorsnee premie") means that younger workers annually contribute the same fraction of their income as older workers and accrue pension rights at the same rate. As the older workers retire sooner their contributions earn an investment return over a shorter period and so the younger workers are contributing relatively more for a given accrual of pension rights. By allowing a uniform accrual rate in DB and CDC schemes employers are not encouraged to discriminate between workers when hiring and firing on the basis of their labour costs (i.e. they do not have to contribute more for older workers to achieve the same level of pension accrual). However when this was translated across to the DC system age-related accrual rates were introduced, so that younger workers had much lower tax favoured annual contributions than older workers. These anomalies between the systems still exist today with maximum contribution rates of less than 5% for those in their early 20s compared to over 20% for those in their early 60s.[4]

This means that a worker leaving an industry-wide plan using "doorsnee premie" and joining a DC plan mid-career can find themselves paying the relatively higher contributions twice. Addressing the anomalies in the tax treatment of private pension saving is an issue of current debate as the Dutch look to transition to a system with more clearly defined individual property rights which could include age-related accrual rates in the collective plans. However, the Netherlands Bureau for Economic Policy Analysis (the CPB) has previously estimated the costs of compensating losers in the transition at €100bn.

2000-2008: Changes to the structure of Dutch pension plans

Dutch pension funds were severely affected by the collapse of the dot.com bubble that took place between 1999 and 2001. At this time many of the pension funds converted their plans (including the accrued rights) from a final salary basis to a career average basis. Under a career average structure the active members also bear the risks of conditional indexation, along with retired members, as they may not see their nominal pension benefits fully revalued, whereas in a final salary structure it would be the final salary at the point of leaving the fund or retiring that is used for the calculation of the benefit.

The number of pension funds offering career average salary rather than final salary structures has risen from 16 per cent in 1998 to 57 per cent in 2014. However as it is the largest funds that have tended to switch the change in membership has been much greater: the number of active participants increased over the same period from 1.2 million (25 per cent) to 5.0 million (89 per cent). The number of active participants in individual DC plans also increased from less than 0.1 million (0.5 per cent) to 0.5 million (8.2 per cent) over that period.[5]

In addition to the industry-wide pension funds changing from final salary to career average structures, a number of corporate pension funds made similar moves, thought to be partly a response to tighter international accounting standards (IFRS) applying from 1 January 2005 onwards.[6] Some high profile examples include Akzo Nobel and DSM (both chemical companies), SNS Reaal Group (a banking and insurance company), and ARCADIS (an engineering company), all of which took steps to switch their plans from DB structures over to CDC structures with any risks around accounting liability removed from the sponsoring employer in the mid 2000s.

As DB pension plans and their successors have dominated the pensions landscape in the Netherlands their DC pensions market is less developed than in the UK. Individual DC plans are required to de-risk ahead of retirement to reduce conversion risk, driven by the strict regulations requiring DC pension savings to be used to purchase a nominal lifetime annuity. The

maximum accrual rates in DB and CDC plans described earlier also allow for the inclusion of a solvency buffer, and can adjust the expected investment returns in line with market prices, and so can justify a higher contribution rate for a given accrual rate. For DC plans no solvency buffer is included and the expected investment return or discount rate is prescribed (now set at 3%, and previously was 4%). Relative to the UK then, DC plans in the Netherlands may look less attractive compared to their DB and CDC counterparts.

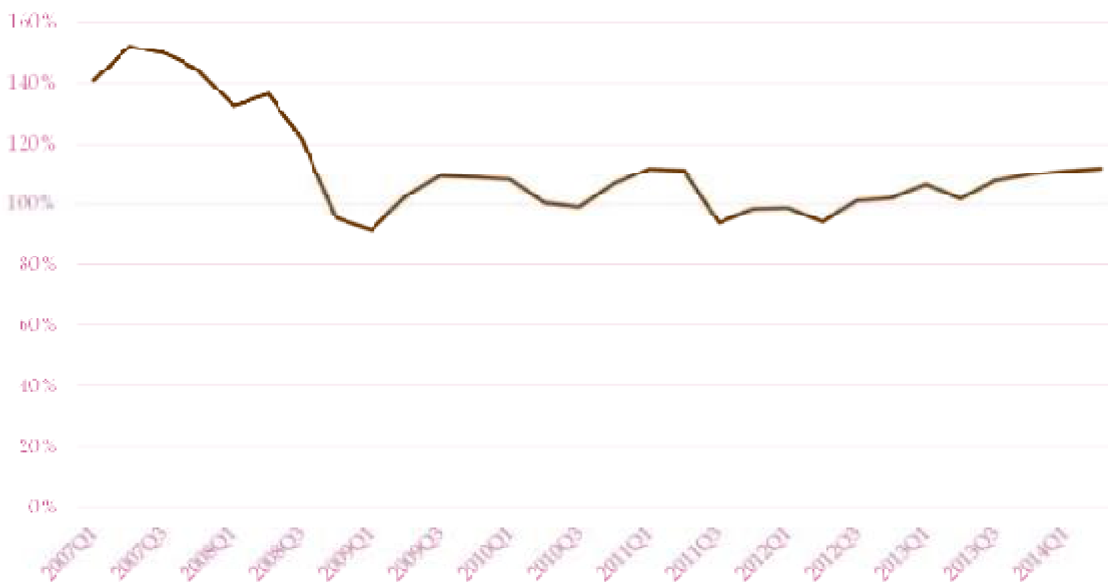
2008-2014: The impact of the Global Financial Crisis on pension plan funding

The Financial Assessment Framework (FTK) for pension funds, supervised by the DNB, requires annual valuations to determine funding ratios against plans "minimum regulatory own funds". The funding ratio is the total assets as a percentage of total liabilities for benefits accrued, with the liabilities excluding any allowances for future increases, and calculated with a discount rate that is broadly risk-free. As a result of the Global Financial Crisis that hit in late 2007, the average funding ratio of the Dutch second pillar pension funds fell from over 150% in the second and third quarters of 2007 to just 92% in the first quarter of 2009.[7]

This was driven by the same "double-whammy" factors that saw rapidly rising deficits in DB plans in the UK and other countries: falling equity prices which reduced assets and low interest rates which then reduced the discount rates and increased the present value of the liabilities of the plans. After a very modest recovery in 2010 the funding levels then fell back

Chart 2: Estimated funding ratios of Dutch pension plans

De Nederlandsche Bank Statistics (September 2014)



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down to levels of 94%-99% in late 2011 and early 2012. The Global Financial Crisis came as a shock, and so did the sudden funding gaps in what had, till then, appeared to be very healthy, well funded Dutch pension plans. However, it is worth noting that not all pension plans suffered the same rapid demise in their funding levels. Around 15-20% of the pension funds, representing around 5-10% of members, managed to avoid their funding ratios falling below 105% during this time, with those funds that had already hedged their interest rate exposure less likely to experience large falls.

In response to the emerging funding shortfalls an immediate step was taken to soften the blow to plans: the DNB announced that recovery plan periods would be lengthened from three to five years.[8] This approach contrasts with the UK's scheme-specific funding framework for DB schemes where there are already significant flexibilities and longer recovery plan periods (typically up to 10 years but sometimes longer) allowed. The announcement by the DNB to extend recovery plans to five years was made in the run up to the 2009 funding assessment process, during which over 340 pension plans had submitted assessments that required them to provide recovery plans to restore them to over 105% funding levels. In addition to the extension of the recovery plan period to five years, it was agreed that any reduction in pension rights would not begin until April 2012 at the very earliest. Some plans, for example ABP, the largest industry-wide plan serving public sector workers and teachers, were able to agree an increase in contributions with their social partners as one of the measures in their recovery plans.

By early 2012 it became apparent that a significant number of pension plans would not restore their funding ratios to 105% within the five year window. Of 298 plans with recovery plans still in place in early 2012, 117 stated that they needed to take additional measures, which could include contribution increases, capital injections from the sponsoring employers or, as a last resort, a reduction in both pensioners benefits and the accrued entitlements of members of working age.

Of the 117 funds needing additional measures, 103 announced that they would have to resort to actual reductions in benefits and entitlements. The weighted average cut at the time was 2.3%, though 34 plans announced an intention to cut by over 7%. For the majority of these plans the cuts were not planned to take effect until April 2013, allowing an opportunity to review the funding position again at the end of 2012. Notably, under the Dutch pensions legislation, plan members only need to be informed one month in advance of any cuts being made. Only 8 pension plans began applying the cuts from April 2012, with a weighted average cut of 6.8%.

In September 2012, following a change in Government (see page 8), a 'September Pension Package' was presented by the Ministry of Social Affairs and Employment to "future-proof" the pension system, and it included the introduction of the 'Ultimate Forward Rate' (UFR) in the calculation of pension liabilities, which is also the rate used within the Solvency 2 framework for insurers who are also supervised by the DNB. The motivation for its introduction was to make the long end of the interest rate yield curve (the discount rate that is used to calculate plan funding levels) more stable and less sensitive to short-term fluctuations in the financial markets.

Pension plans funding positions did indeed improve towards the end of 2012 to an average of 102%, largely as a result of the regulatory rise in the discount rate and the introduction of the UFR (which at 4.2% was significantly higher than the prevailing discount rate at the time). The introduction of the UFR was not without controversy, as the improvement in reported funding ratios could potentially delay pension cuts and alter investment decisions, with associated concerns around intergenerational fairness and transfers from younger generations to

the old.

Despite the improvement, the pension plans monthly reports in December 2012 did lead to the announcement in January 2013 that 68 pension plans would still need to apply cuts in pension benefit payments from April 2013.[9] These cuts were applied uniformly to pensions in payment and accrued entitlements from April 2013, affecting 2.0 million active members, 1.1 million retirees, and 2.5 million deferred members. The weighted average cut was 1.9%.

Further cuts were anticipated for around 40 pension plans for April 2014, conditional on further changes in the funding position. In the event, funding positions had improved a little by late 2013 (partly due to pension cuts having been made), to an average funding position of 110%, with only 29 pension plans then required to make further cuts to pensions in payment and accrued entitlements in April 2014. While the cuts were not welcomed by the public, they did demonstrate the ability of the Dutch plans to take early action to respond to funding problems.

Early 2010: the Goudswaard and Frijns Committees

During the period of relative turmoil between 2007 and 2013 there were ongoing discussions on the future of the Dutch pension system. The Goudswaard Committee was formed of Dutch pensions finance experts and was asked by the Social Affairs Minister to investigate the effects of the financial crisis and population ageing on the long-term sustainability of the Dutch pension funds. Reporting into that Committee, the CPB had calculated that pension contributions would need to rise from 13% of gross salary to over 17% by 2025 to maintain the current level of pension provision.[10]

In response, the Goudswaard Committee recommended in January 2010 that the social partners agree to a lower pension than the expected norm of 70% of the final salary at retirement age, and that this change be implemented directly by reducing the accrual rates for active members within existing plans. In addition, they advised that alternative methods for controlling longevity risks could include a capped pensionable salary, indexation linked to the consumer prices index rather than earnings, and explicitly incorporating rising life expectancy in the pension funds through automatic adjustments to pension benefits or retirement ages. The Committee also acknowledged that such changes might require more detailed and transparent pension contracts, including exploration of the effects of age-dependent pensions accruals. The trade unions were supportive and agreed with the Committee's proposals for improved clarity and durability in the contracts, although left the door open for some future increases in contributions as well.

Also in January 2010, the Frijns Committee, whose remit covered investment policy and risk management, made supporting recommendations to suggest that pension plans should alter their investment policy in line with the risk levels that plan members are prepared to accept, rather than being driven mainly by returns. This would include encouraging pension plans with an older membership to take less risk than schemes with mainly younger workers, and for trustee boards to make clear choices about the levels of risks being carried by the different groups of participants within the plan. The aim would be to more clearly communicate with members the reasons behind investment policy decisions and the inherent risks within the pension plan. The Frijns Committee also recommended that plans should set stricter limits on the funding ratios that are acceptable before decisions are taken to reduce benefits and/or increase contributions. Underlying their recommendations was the recognition that an ageing population increases the vulnerability of pension plans, as they are receiving less in contributions relative to the size of the plans total liabilities. Finally, the Committee argued that the focus in future should be on a 'real' rather than 'nominal' contract (see next section for an explanation), to take into ac-

count the true value of obligations and the cost of future indexation.

2010-2014: Negotiations between the Government and other partners around a new Financial Assessment Framework

Shortly after, in March 2010, proposals were presented by the Ministry for a revised Financial Assessment Framework (FTK). A new pension agreement—the Pensioen Akkoord— was then signed by the Dutch social partners in June 2010. In it they agreed to increase the retirement age for both state pensions and occupational pensions from 65 to 66 in 2020, and then reassess it every five years for changes in average life expectancy. They also set out the basic principles for shifting more of the risk to the employee through a new, more transparent pension contract that takes into account developments in life expectancy and the financial markets. It was agreed that this new contract would require a revision of the Financial Assessment Framework.

There were broadly two options put forward for the nature of contracts:[11]

- A 'nominal' contract—based on the existing DB career average plan structures with conditional indexation, but with higher funding ratios/ solvency buffers now required to deliver the nominal benefits with 97.5% certainty, and with full indexation only allowed to be paid once a plans funding ratio has reached (typically) 125-130%. These are often referred to in the literature as 'old', 'nominal' or 'DB' contracts.
- A 'real' contract—based on assuming that real (or fully indexed) benefits will be paid, but with full conditionality rather than higher funding ratios/solvency buffers, meaning that any under or over funding is adjusted for and allocated to members immediately, although the effects could still be spread over a 10 year recovery period. These are often referred to in the literature as 'new', 'real' or 'DA contracts'.

The aim was that the revised Financial Assessment Framework could apply to both types of contracts, and that all employers would then have the choice of whether to keep the nominal contracts or to shift to the new 'real' contracts.

However, there were some sticking points with the proposals, in particular the issue of how to handle accrued DB pension rights. One option was for all existing DB pension rights to be frozen and ring-fenced, while another option was to allow them to be regulated under the new rules for the 'DA' or 'real' pension contracts, to ensure the future affordability of the plans. There was not a clear view on whether conversion of the accrued DB pension rights would be legal. Many pension lawyers considered conversion to be at odds with European case law. The Dutch Ministry of Social Affairs and Employment was more optimistic - believing that such a conversion could be potentially justified on the grounds of public interest to ensure that the Dutch pension plans were sustainable.[12] In practice neither the social partners or the pension funds, who would ultimately need to be the ones implementing the changes, were willing to take on the associated legal risks.

Another sticking point was around the value of the 'real' contract, how the future liabilities would be discounted, and within that the treatment of inflation expectations, with associated political risks around how these parameters would be set in future. While discussions on the Pensioen Akkoord were still ongoing there was a fall in Government in April 2012, following difficult political discussions on austerity measures. The immediate discussions then turned instead to the introduction of the UFR, as outlined in the September Pension Package of 2012.

2014: Latest developments

After much negotiation, the Dutch Cabinet finally approved proposed changes to the Financial Assessment Framework (FTK) on 20 June 2014. These were debated in Parliament and agreed in October 2014. They

focus on tightening up the existing nominal contracts and include a range of measures which, as a package, clarify the new processes for funding valuations, recovery plans and remedial action when a pension fund is in a position of under funding. These aim to address the five policy conclusions of the Dutch Government, as outlined in Chart 3. The proposed measures below will either be required or allowed:

- Discount rates will be based on the new UFR approach for periods after 1 January 2015, resulting in lower discount rates compared to the current approach.
- Higher solvency buffers will be required in order to realise the legally required degree of actuarial certainty (97.5%). Indexation will only start to be awarded if funding ratios are above 110%. Full indexation will only be allowed at funding ratios above 130%, though the precise funding ratio required will be plan specific depending on the maturity of the membership.
- A smoothed discount rate over a (maximum) 10 year period to determine the required contributions will be allowed. It will also still be possible to use the expected return on assets as the discount rate for determining the required contributions under certain conditions, including financing and future conditional indexations (instead of the solvency buffer).
- A 12 month moving average funding ratio will be allowed, replacing the current point estimate funding ratio – this funding ratio is relevant for the decisions related to indexation, benefit reductions and recovery plans.
- An extended recovery period will replace the current

Chart 3: The Dutch Government's five "policy conclusions"

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Source: based on De Brauw legal alert, July 2014

Policy Conclusion	Solutions
1. Abrupt and sizeable reductions in pensions should be avoided where possible. It is preferable to spread windfalls and setbacks over time. At the same time, the delay of necessary reductions should also be avoided.	Rolling 10 year recovery plans, recalibrated annually, will replace the current fixed term plans. Additional measures will guard against funds running a perpetual recovery plan.
2. An investment policy that is aimed at generating returns and realising an index-linked pension over the longer term should not be jeopardised by the fixed term of the recovery plan.	Rolling 10 year recovery plans lessen the incentive to shift investments into low-risk assets when approaching the 105% funding level.
3. It is desirable to mitigate the effects of changes in current market rates, in order to reduce volatility and maintain stability in the funding requirements of the pension funds.	12 month average funding ratios are allowed and discount rates can be smoothed.
4. The financial assessment framework should not increase volatility in contributions or generate undesirable macro-economic effects.	The requirement that the pension contribution must pay towards the recovery will be removed.
5. The legal solvency certainty standard of 97.5% (i.e. that there is only a 2.5% chance that the funds "own capital" will experience a shortfall within one year) requires a higher buffer.	A higher solvency buffer (typically between 125-130%) will be required; there will be stricter indexation rules.

recovery plans and there will be a rolling 10 year recovery plan when funding ratios are below the full funding level of around 130%.
- Benefit reductions will be required when the recovery to the full funding level within 10 years is not expected. Reductions will amount to one tenth of the deficit.
- Further benefit reductions will apply when funding ratios are below 105% on six consecutive annual measurement dates.
- The requirement for contribution increases for recovery has been dropped, as it only affects the active members. It is however allowed.
- Schemes must outline ahead of time how they intend to deal with any funding windfalls or setbacks they might encounter in the future.

New "feasibility tests" will also be introduced to replace the current continuity analysis and will focus more on the feasibility of the aspired and expected retirement income and the associated risks. The DNB will specify the technical assumptions and the set of pessimistic scenarios that should be stress-tested by plan administrators and then communicated to plan members so that they are more aware of the downside risks to their future retirement incomes.

There is widespread acknowledgement that these proposals are not the end of the story, but seek to stabilise the Dutch pension plans in the short-term. The intention is for the changes to take effect from 1 January 2015, and pension plans will have until 1 July 2015 to meet all of the requirements of the new actuarial rules for financial crisis planning, investment and indexation policy. The revised Financial Assessment Framework is expected to push up the target funding ratios, increasing them to around 125-130% for most plans.

An emerging consensus on the benefits of CDC versus IDC?

While the discussions and negotiations on pension reforms and the revisions to the FTK have been taking place there has been a growing consensus within the Dutch pensions community on the structural differences between CDC and Individual DC (IDC) and the quantitative effects of intergenerational risk-sharing. The organisations involved have included Netspar, the Central Planning Bureau (CPB), the Ministry of Social Affairs and Employment (SZW), the DNB, Cardano, APG (the service provider for ABP) , PGGM (the service provider for PFZW) and Ortec Finance.

In theory, the optimal allocation of risk can be achieved in CDC schemes if positive and negative shocks and their consumption effects are smoothed over all current and future generations. However a recent joint statement, issued by Netspar and the CPB, argued that the advantage that collective DC pension schemes have in the Netherlands, relative to individual DC pension schemes, is decreasing.[13]

The advantages come from the ability of the CDC pension schemes to share risks with future generations (including generations not yet in the labour market), which allows them to pursue riskier investment strategies, on average. They also have the potential to manage changes in inflation and absorb changes in life expectancy. For example, if there is a period of unexpectedly high inflation, those who are not yet retired can help to meet the higher costs of indexation as they are still participating in the labour market and their wages (and contributions) are likely to grow in line with increases in prices. Similarly, if there is an unexpected increase in life expectancy, those who are not yet retired can work for a little longer to help offset the costs of the retired cohorts living for longer than had been expected when their benefits were being accrued.

However, due to population ageing and the increasing flexibility of the labour market in the Netherlands it is argued that the opportunities for risk-sharing across cohorts are diminishing. The extent to which trading risks across cohorts is considered desirable is also a matter for political debate. For example, automatic stabilisers

that reduce the benefits of older generations to offset longevity shocks (based on more individual contracts) may be preferred to assuming there will be longer working lives and further longevity improvements amongst the younger generations (based on more collective contracts). This ability of the younger cohorts to share risks becomes more of an issue where there is an ageing population and so younger cohorts ability to absorb shocks that relate to the costs of the retired cohorts benefits is diminished. These arguments would also apply to the UK, which faces similar ageing and demographic challenges to the Netherlands.

Another constraint on the degree of risk-sharing is that, in practice, the presence of very high deficits or surpluses within a pension fund can lead to discontinuity risks. For example, a high funding deficit may deter younger workers from participating in the plan knowing that they are already taking on a funding gap when they enter the plan and start making contributions.

Discontinuity risks are reduced in pension funds that are organised directly by the state, or that are implemented either at a national or industry-wide level under principles of solidarity and where there is mandatory participation (i.e. there is limited opportunity for employers or workers to leave and switch to another fund). However, large deficits or surpluses still carry some risk as they can provoke political debates at a national level about the long-term sustainability and intergenerational fairness of the plans. Large surpluses, for example, can lead to political pressures from older and current generations to redistribute positive buffers through reduced contributions and/or higher benefit payments.

For that reason, Dutch pension funds (just like DB plans in the UK) are required by the regulator to carry out regular funding valuations and, in the case of a deficit, to agree recovery plans that commit to a method and timeframe over which any deficits will be filled. During the financial crisis this was extended from three years to five years and, under the proposed revisions to the Financial Assessment Framework, will now be extended further to ten years.

The inclusion of a ten year recovery plan within the regulatory framework restricts the sharing of risk to those who are either currently members of the fund or who will become members within the next ten years. Likewise, the oldest generations who die before the end of the ten year recovery window will only absorb part of the impact of the shock as they will die before a full adjustment for the shock has been made.

The Dutch academic literature also increasingly focuses on the risk-sharing benefits of collective pension contracts *over and above* the benefits from collective DC contracts taking a riskier investment strategy than individual DC contracts. Previous estimates made in the UK of the potential benefits of CDC have assumed that i) retirees within individual pension contracts purchase an annuity at retirement and ii) the asset allocation within the CDC plan is relatively higher risk than in an IDC plan.

For example, an estimate quoted by the RSA assumed a 37% improvement in pension outcomes from CDC compared to IDC, 10% of which was attributable to lower costs, 22% of which was attributed to not annuitising and 5% of which was attributed to a less conservative investment strategy in the run up to retirement.[14] The Government Actuary's Department (GAD) produced modelling on CDC schemes in 2009 and found that retirement outcomes from CDC were 39% higher on average in their simulations, again largely attributable to assuming a less conservative investment strategy is taken in the run up to retirement and that annuitisation does not take place at the point of retirement.[15]

However, when a life-cycle investment strategy is used in an individual DC plan that carries

some investment risks on into retirement (and allows for fluctuating indexation and benefit payments in retirement) it is likely that the gains from the CDC arrangements would be reduced. The Dutch academic studies are increasingly calibrating the investment strategies between CDC and IDC schemes to further isolate the potential gains from risk-sharing. This is particularly relevant in the UK where, as of 1 April 2015, there will be no requirement for retirees to annuitise their DC pension savings at retirement.

The benefits from CDC pension schemes are therefore increasingly focused around:

- Their ability to trade risks that can not currently be traded in the markets, including (depending on the availability of inflation linked instruments) inflation risk (which younger workers can hedge on behalf of retired cohorts through their access to human capital), and longevity risk;
- The broader "collective" benefits of a CDC scheme including the lower governance, administration and investment overheads of offering schemes at scale. Note that at least some of these benefits can be delivered for individual DC contracts as well through establishing larger plans with collective asset management and service provision.

Lessons for other countries in developing shared risk and collective benefit schemes

A Netspar occasional paper, *The promise of Defined-Ambition plans: Lessons for the United States,* reflects on what other countries with a mix of existing DB and DC provision can learn from the experiences of the Dutch pension funds.[16] They highlight four positive features:

i) Coming from a DC perspective, using a "consumption frame" to improve the communications and risk management in DC schemes and communicating to members in terms of their likely lifetime income streams. Viewing income streams as liabilities should also encourage greater use of hedging strategies in DC investment.

ii) The potential for collective structures to address systemic longevity risk without the drawbacks of hard-wired guarantees and external insurance (including costly solvency/ capital buffers) or mutual insurance with collective buffers and unclear ownership rights. This can be achieved through, for example, restricting the pooling of investment, inflation and longevity risks to just the pay-out phase to reduce intergenerational conflicts.

iii) The potential for collective structures to allow retirees to still benefit from risk premia in retirement without large fluctuations in their consumption patterns through allowing a continuation of life-cycle investment and a smoothing of the consumption effects of unexpected shocks.

iv) Coming from a DB perspective, allowing employers to discharge the liabilities from their balance sheet, while still enabling them to play a role as a distributional platform for workplace pensions, including in the setting of defaults, tackling agency issues through buyer power and collective procurement, and pooling longevity risks.

2014 and beyond: Other developments in the Dutch Pensions Landscape

The Dutch parliament has now agreed the proposed revisions to the Financial Assessment Framework with the expectation that the Framework will apply from 1 January 2015. However, the view of the Government, the regulators and the industry is that there are many fundamental issues still to be resolved—with the DNB describing the latest package of measures as "technical maintenance."[17]

A much broader debate has just been launched by the Ministry for Social Affairs and Employment under the umbrella of De Nationale Pensioen-dialoog (the National Debate of Pensions) which focuses on the themes of solidarity, freedom of choice, collectivity and responsibilities. The debate will have a longer term focus compared to the measures that have been

taken by the Dutch Government thus far. Specific issues being grappled with, which are inter-related, include:

- **Outstanding issues around the nature of property rights and fair market prices in the Dutch pension contracts.** The CPB have previously concluded that, while the introduction of more individualised property rights (for example, ensuring that the pensions rights are age-related and linked to the actual contributions being made) would be feasible, it could cost in the order of €100bn euros to compensate losers during the transition. There is also an underlying concern that making the system more transparent with clear ownership rights will pave the way for the ending of mandatory participation in future.
- **Employers appetite for freedom of choice in their pension offering.** Currently employers wishing to leave an industry-wide pension fund need special dispensation from the pension funds trustee board to do so. Only a small number of large employers who can afford a very generous pension offer for their workers have so far managed to do so but some sources report that there are a growing number of employers looking at this option. Their options range from setting up their own company individual DC plan (either their own corporate pension fund or through an insurer) to establishing their own form of CDC arrangement. There are live discussions about innovative CDC solutions that could be adopted, for example rollover DC schemes that shift into collective arrangements as workers approach retirement to reduce investment risk and share the longevity risk across older cohorts. Insurers are also looking to innovate in this space though are constrained by the current regulatory requirements that mean an individual DC pension fund must be used to purchase a nominal annuity at retirement. Liberalisation of the regulations around how DC pension funds are accessed at retirement could see individual DC plans start to look relatively more attractive.
- **Changing labour market dynamics and the growth of self-employment.** The Ministry for Employment and Social Affairs has raised the growing prevalence of self employment as a key challenge for the Dutch pensions landscape, alongside underlying changes in the labour market that may mean industry-wide pension funds with mandatory participation and limited choice are increasingly less attractive to workers. De Nationale Pensioen-dialoog is seeking to address some of these issues.

It seems, therefore, that the Dutch pension model may be edging closer towards the UK pension model (post Pension Schemes Bill), in terms of freedom of choice and the need for greater innovation both for employers and workers across the pensions landscape. The experience of the Netherlands has demonstrated a reluctance to convert the existing nominal contracts over into the so-called 'real' contracts. The UK is in a more extreme position, with protection of accrued DB rights and the statutory indexation of those rights hardwired into our own primary legislation. There is currently little political appetite to review this position, and so, unless stringent requirements were met to modify members benefits, CDC plans in the UK would need to be newly established for employers with existing DB or DC plans rather than converted from their existing plans, with their own separate governance arrangements.

Specific lessons for the UK

Turning to the application of the lessons from the Dutch experience of risk sharing pension plans to the potential plans that could be set up in the UK, the following points are worth highlighting:

i) To avoid the negative reactions that have been experienced by the Dutch pension plans when making cuts, the contractual agreements and members' expectations should be fully aligned from the start.

The need to reduce or stop indexation, and cut nominal benefits, will always come as a disappointment to plan members. However it appears in the Dutch model that there was a failure from the outset to align members' expectations with the possibility that conditional indexation may not be paid out in all future years and that, under certain circumstances, benefits may even be cut. It therefore came as a shock in 2012 when nominal cuts were made for the first time. This is now being partly addressed in the revised Financial Assessment Framework, in particular through the feasibility tests and revised member communications that will be more explicit about the downside risks.

Under the proposed legislation in the UK Government's Pension Schemes Bill a plan where there was a possibility of a reduction in benefits would be categorised as not containing a promise (rather than evolving from a DB plan) and would therefore fall under the DC category. "Complete" contracts—where trustees responsibilities and actions when in a position of under and over funding are agreed and communicated in advance (as in the New Brunswick Shared Risk Plans in Canada) - can also help to manage expectations but will inevitably still involve some degree of judgement or discretion, for example around the selection of actuarial assumptions or the extent to which different actions are used.

ii) Automatic-enrolment with the possibility of opt-out, rather than mandatory participation, makes clearly-defined individual property rights even more critical within a collective benefit structure. The average contributions currently paid into the Dutch DB and CDC plans, irrespective of a members age, have meant that, to some extent, the system has been operating with cross–subsidies, with younger workers paying a relatively higher contribution for the benefit they accrue. The solidarity argument holds if all members stay within the plan and benefit from the relatively lower contributions when they are older. But in an increasingly flexible labour market where workers may switch in and out of different forms of employment and different pension schemes (e.g. may leave a CDC scheme and join a DC scheme or vice versa) younger workers are less likely to stay within one plan throughout their life course. To avoid these issues in the UK where job moves are relatively frequent, and to ensure a level playing field between different scheme types, individual property rights should be clearly defined within a collective structure—for example by allowing "degressive" or age-related accrual structures where the accrual rates reflect both the contributions that have been paid in and the expected investment returns, and by also assigning ownership rights to any collective buffers that are held by the scheme. In the UK context, where members can opt-out and choose to vary their contribution levels over time, any inherent cross-subsidies could destabilise the scheme.

iii) **Scale in itself can deliver significant 'collective' benefits.** One of the benefits of the Dutch plans is that they are organised at an industry level and therefore benefit from economies of scale around administration and governance. The pooled investments can also drive lower investment fees and the mandation on employers reduces the distribution costs for the plans (they do not need to market their services to attract employers, although they do have to show that they are not under-performing or employers can vote with their feet). The high average contribution levels seen in the Dutch pension plans may also reduce some of the operating costs, particularly around investment fees, although the strict separation of the pension funds from the employers means that the governance overheads are met directly by the contributions from the scheme (rather than the employer, as is generally the case in the UK for trust-based schemes). The scale that is now being built up in the UK, for example through automatic enrolment and the

development of DC mastertrust arrangements with hundreds of thousands of members, should help to deliver some of the scale aspects of 'collective' benefits within the UK.

iv) A major benefit of collective benefits is the ability to pool individual (micro) longevity risk outside of an insurance wrapper to reduce the costly solvency/capital buffers. The drawback is of course that there is a possibility that members indexation and nominal benefits may be reduced in future. With the changes announced at the Budget 2014 there is greater flexibility for pension schemes and providers to offer innovative collective drawdown strategies that could include some pooling of longevity risks for retiring cohorts. A challenge would be avoiding adverse selection which could require some form of pre-commitment or lock-in to the arrangement once selected, or for individual longevity risk to only be pooled across relatively homogenous groups of retirees (e.g. those with similar socio-economic backgrounds and health). Alternatively, only a part of the pension fund could be allocated on a collective basis to pool longevity risk which could also reduce the potential selection effects.

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