Holding back the flood

Dutch pensions are both simple and rational, writes **Oonagh McDonald**

Dutch occupational pensions are widely admired, and for good reason. They are a little like the system of Dutch polders and dykes – a collective undertaking that holds back a tide that could otherwise swamp much of what its citizens recognise as Dutch.

The pensions bulwark is needed because the Netherlands, like the rest of Europe, faces a rising flood of dependent elderly. The challenge for all ageing, developed countries is how best to protect standards of living in retirement.

The solution in the Netherlands consists largely of sector-wide schemes, jointly overseen by employers and employees. Membership is mandatory for workers within a sector once the social partners have made a collective pension agreement. More than 90 per cent of Dutch employees are members of a scheme like this, contributing about 20 per cent of their salaries. These pensions constitute the major part of the average employee's retirement income (50 per cent) with another 40 per cent from the state pension and 10 per cent from private pensions. Overall, the schemes aim to provide 70 to 80 per cent of the gross annual wages earned over a career. Around 60 per cent of the self-employed are also members of similar, pooled, schemes.

The structure of Dutch schemes gives them a number of advantages over UK company pensions. Because the system is mandatory it cuts out marketing and distribution fees and, because large numbers are involved, it enjoys economies of scale in administration and asset management. Also, organisation at the sector level means that those who move jobs face no pension transfer costs.

These strengths mean the structure of Dutch pension provision has not changed in the post-war period. However, shifting demographics affect the Netherlands too, so some significant changes have been made. Final salary schemes have been replaced with pensions based on career averaging, and compulsory indexation has now been changed to conditional indexation. Contribution rates are variable and benefits are reduced if the funding ratio of a scheme stays below the requirement set by the Dutch central bank.

The funding ratio is that between the available assets of the fund and its liabilities, both at market prices. This is supposed to be above 105 per cent but additional buffers (equity) are required to give inflation compensation (indexation). For an average fund, the required funding ratio to give full indexation should be between 125-130 per cent. Currently, the average funding ratio is about 97 per cent. When the ratio slips below the target, the fund must submit a recovery plan to the

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jhregulator, showing that the scheme will reach the required funding level within three years. If the ratio recovers sufficiently, indexation may be restored with additional payments, allowing active, and retired, members to catch up.

This sort of requirement could be very onerous for one company but, as the schemes are industry-wide, the burden is spread and a company does not take the liabilities onto its balance sheet. The implications of the funding shortfall are clearly explained to all scheme members. The board of trustees, who carry responsibility for the investment policy of the fund, draws up the recovery plan and keeps all members informed.

The occupational pension schemes were funded well above the 105 per cent before the credit crunch in 2007 and are now in recovery mode with most being underfunded largely because the fall in the discount rate has increased their liabilities. Some of the schemes have announced a cut in pension provision of up to 15 per cent, beginning in 2013.

Clearly, larger funds are better able to ride out the financial crisis. The biggest has more than a million members, with invested capital of over €150bn, but others have fewer than 100 members and just a few million euros invested. There has been consolidation among funds over the past 10 years, down from around 1,000 to 450, and the Dutch government has been trying to make the funds stronger. The Pensions Agreement of 2011, for example, requires them to take longevity explicitly into account. Parliament voted for an increase in the official retirement age to 66 in 2019 followed by a rise to 67 in 2023, when the pensionable age will be linked to life expectancy.

This is likely to increase the Dutch pension funds' combined liabilities by 5-6 per cent. Future longevity assumptions could increase liabilities by another 7 per cent, according to the IMF. There is some disagreement over these figures. The Actuarial Association calculated that liabilities increased by 1 per cent on the basis of its new mortality prognosis table (2012-2062), which also finds that male life expectancy increased faster than female life expectancy. Its model has abandoned the assumption that women have a lower mortality risk at each age than men, and the assessments of life expectancy at the higher age groups has been modified. However calculated, the link with life expectancy tables will lead to higher retirement ages being set automatically.

All in all, the simplicity and rationality of the Dutch system contrasts well with the endless reforms and increasing complexity of the UK approach. The structure has shown itself to be sufficiently robust and flexible to withstand dramatic economic and social changes over 60 years.

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