

# Agenda

Advancing economics in business

## Dutch lessons: defined-ambition pensions in the Netherlands

On November 22nd 2012, the UK Department for Work and Pensions published 'Reinvigorating Workplace Pensions', in which it proposes the introduction of a new category of pensions in the UK market: defined-ambition (DA) pensions. Dr Thurstan Robinson, AEGON Global Pensions, and Erik Schouten, AEGON Adfis, take a closer look at DA pensions, and examine the Dutch experience of introducing them

The UK Department for Work and Pensions' (DWP) report 'Reinvigorating Workplace Pensions' is a new strategy document 'for putting in place arrangements that result in the provision of high quality pension schemes'.<sup>1</sup> The paper covers a range of topics, but one of the most significant changes suggested is the introduction of a new category of pensions in the UK market: defined-ambition (DA) pensions. So, what are they, what will they do, and what can the UK learn from the Netherlands, which is in the process of introducing them?<sup>2</sup>

### The decline of defined-benefit pensions

Good pensions increase employee commitment.<sup>3</sup> From an employee's perspective, a good pension is one that will pay an adequate—and predictable—stream of income in retirement (until death). However, from an employer's perspective, providing such a pension has become increasingly difficult and costly.

For most employers in the UK, it is clear that the risk and burden of providing defined-benefit (DB) pensions have simply become too great. Companies have therefore overwhelmingly moved towards providing defined-contribution (DC) pensions. In the UK, 54% of companies now provide DC pensions only, with a further 41% of companies in transition.<sup>4</sup>

### Transferring risk

Although DC pensions may make things easier for employers, they achieve this by transferring risks to employees—risks that employees often do not understand and may not be able to deal with.<sup>5</sup> The consequences of this transfer are not hard to see—most employees in the UK with DC pensions are

currently saving too little for retirement and have little concept of the consequences of longevity risk.<sup>6</sup> It is clear that employees require assistance. One of the proposals that has been put forward (in a number of guises) is DA pensions.

Employers are looking for predictable pension costs; employees are looking for predictable pension outcomes. DA pensions would appear to provide a perfect compromise. But what are they, and what exactly are they promising to do?

### Defined ambitions

DA pensions reintroduce (or maintain) the concept of an employer bearing some risk on behalf of their employees. However, there are currently a number of different DA proposals, and it is important to be clear about which is being referred to.

#### DA from DB

The first type of DA pension (and the one being implemented in the Netherlands) can perhaps be best described as DA from DB (DA/DB)—that is, it is a modification of the DB pension system in which a pension fund continues to operate as before, but instead of promising to provide a pension based on average career salary, the employer promises to target a specific pension based on average career salary on the condition that employer contributions will not have to be raised in order to achieve this. Unlike DC, the employer is taking responsibility for trying to deliver a specified retirement outcome but, unlike DB, is not bound to deliver that outcome at all costs. As a result, companies no longer have the volatility and risk of DB pensions, and employees receive more support and certainty than with most DC pensions.

## DA from DC

The second type of DA pension being proposed has been described as DC plus pensions (DA/DC). These range from collective defined-contribution (CDC) pension plans to fairly straightforward money-back guarantees on DC investments. The recent DWP strategy paper lists features that could be used to provide DA pensions, including bulk-purchased annuities, guaranteed returns on investment, and a separate employer's fund used to smooth returns of employees' funds through annual or terminal bonuses (a sort of partial CDC). CDC itself is not currently possible in the UK, but some forms of DA/DC pensions are in use, such as the cash balance pension provided to employees by UK supermarket chain Morrisons.

## Looking to the Netherlands

Can the UK learn anything by looking at the experience of the Netherlands—a country with CDC pensions that is currently looking to introduce DA/DB pensions?<sup>7</sup> The Dutch CDC plans link benefits, in most cases, to career-average earnings, and benefit indexation depends on the plan's funding position. Employers contribute a fixed percentage of wages into these plans and bear no additional liability if the investments of the plans perform poorly or if the interest rates used to calculate liabilities decrease. Normally, the contributions for CDC plans are fixed for a period of time—for example, five years. After that period, contributions are renegotiated.

With CDC, the investment and longevity risks are transferred from the employer to the pension plan and thus to the employees as a group. CDC plans deliver efficiencies through intergenerational risk-sharing and economies of scale. If a CDC plan becomes underfunded, the plan's governing body decides how to restore the full funding position. This can be achieved by reducing indexation, lowering the future accrual rate and, if necessary, by reducing accrued rights.<sup>8</sup>

## Dutch DB

Current DB pensions in the Netherlands would already fall into the DWP's DA category—Dutch DB plans currently offer partially conditional, non-indexed pensions. If a Dutch DB pension plan is unable to meet its pension promise, it can postpone indexation and (as a last resort) may also lower pensions in order to become fully funded again. However, rising costs and the volatility of pension liabilities have led to the creation of a new pension contract, the legislation for which is expected in 2014.

Once introduced, the legislation will enable pension funds and company sponsors to choose to keep their old, nominal DB pension contract or to change to

the new, real DA pension contract that will fix future employer contributions at the present level.<sup>9</sup> Among the key points of the proposals are mandatory agreements between the social partners (trade unions and employers' organisations) and the pension funds about sharing financial risks between older and younger generations. New rules must also ensure proper and uniform (standardised) communication.<sup>10</sup> The Dutch Ministry of Social Affairs and Employment also wants pension funds to develop a mechanism for the automatic adjustment of pension rights, benefits and pension target age in line with life expectancy. This mechanism would become mandatory for real DA pension contracts but could also be applied to indexation under the existing nominal DB contract.

## What about accrued pension rights?

One of the biggest issues at present with the move to DA in the Netherlands is how to deal with accrued pension rights. This topic seems to have been largely missed in the DWP strategy document, but the issues would be identical to those in the Netherlands if DA were to be introduced in the UK. The question is: should current accrued DB pension rights be frozen and ring-fenced, or should they be regulated under the new rules for DA pensions? Is it legally possible to institute a mandatory transfer of accrued benefits into the new system? If it is, benefits that are currently considered to be unconditional would become conditional.

In the Netherlands, for the new pension agreement to be successful, such a transfer of accrued pension rights is necessary. As a result of rising longevity and developments in the financial markets, continuation of the existing nominal pension contract is no longer affordable. Without bringing the accrued pension rights within the remit of the new rules, it would take decades before the advantages of the new pension contract would be seen.

Although many pension lawyers consider a mandatory transfer of accrued rights to be in conflict with European case law,<sup>11</sup> research by the Dutch Ministry of Social Affairs and Employment indicates that it may nevertheless be possible.<sup>12</sup> Even though a mandatory transfer of accrued pension rights is a breach of the right of ownership of participants of the pension fund and retirees, the Ministry believes it could be justified in the public interest by making occupational pension plans sustainable. The mandatory transfer is required to maintain solidarity between younger and older generations by means of risk-sharing in the pension fund.

According to the Dutch Ministry of Social Affairs and Employment, merging existing nominal pension rights into a new real pensions contract is legally possible. However, the system has not yet been tested. It is clear from the DWP paper that such a radical transition is not currently being considered in the UK. Instead, the UK might attempt to introduce conditional or optional indexation for all DB plans (as proposed by the DWP).

### Can DA play a role in the UK?

If companies are unable to transfer accrued DB pension rights into DA pension rights, it seems less likely that many will choose to move to DA/DB pensions, except perhaps as a first step in de-risking when moving to DC pensions. The majority of companies in the UK have already made the shift to DC pensions, so a DA/DC pension seems a more likely alternative.

CDC pensions have been proposed in the UK a number of times, and are covered once more in the DWP paper.<sup>13</sup> However, the paper appears to indicate in advance that introducing CDC to the UK would be difficult, and that, to be effective, CDC depends on economies of scale. Once again, the Dutch experience could be beneficial, as hybrid CDC plans exist in which individuals have the choice of investing independently or participating in CDC funds. The company guarantees a return on the CDC element but not on the individual investments. Additional provisions, such as guaranteed funds, are also available in the Netherlands although, as in the UK, guaranteed funds might provide an element of security and certainty that has to be balanced with lower returns (and thus the requirement for higher contributions). Guarantees provide a clear benefit to employees, but they come at a price.

### Helping employees to save for retirement

As stated above, many company DC plans in the UK are at risk of not delivering the pensions that individuals expect or need, and many employers are therefore looking at how to improve their DC plans. UK workers are some of the least committed (in terms of motivation and loyalty) to their employers in Europe.<sup>14</sup> Providing them with a pension that will increase their optimism about retirement (and thereby increase their commitment) may prove beneficial to both employers and employees.

DA pensions in a DC world do not so much require any single specific mechanism (as the array of proposals in the DWP paper shows) as a change in mindset and behaviour. They require companies to look again at the pension promise that they wish to make, and at how willing they are to assist their employees in achieving an adequate income in retirement.

The DWP paper provides something of a 'shopping list' for DA pensions, and may leave some people more confused than enlightened. However, it will hopefully provide companies and consultants with food for thought about creating new DC plans that will give employees more certainty about their retirement—in terms of both the savings/accrual phase and, importantly, the payment phase. The experiences in the Netherlands with various forms of DA pensions (CDC, conditional indexation DB, DC with guarantees, and the DA/DB pensions that are soon to be introduced) may help both the UK government and companies to design a sustainable and effective occupational pension system for the future.

### Dr Thurstan Robinson and Erik Schouten

<sup>1</sup> See Department for Work and Pensions (2012), 'Reinvigorating Workplace Pensions', November, chapter 3, 'Providing greater clarity and building confidence,' pp. 29–43.

<sup>2</sup> For a more in-depth discussion of DA pensions and pension reform in the Netherlands, see Robinson, T. and Schouten, E. (2012), 'Defined Ambition Pensions – have the Dutch found the Golden Mean for Retirement Savings?', *Pensions: An International Journal*, 17:4, forthcoming.

<sup>3</sup> Recent research by AEGON (in which 9,000 employees in nine countries were interviewed) showed roughly a 12% increase in commitment from employees who felt confident about their retirement. See Green, M. and Robinson, T. (2012), 'Expatriate Pensions and Employee Commitment', AEGON Global Pensions White Paper, p. 10.

<sup>4</sup> Association of Consulting Actuaries (2011), 'Workplace Pensions: Challenging Times: 2011 Pension Trends Report', January 3rd, p. 10, Figure 4.

<sup>5</sup> For example, a recently published survey by the Institute for Fiscal Studies (IFS) revealed that 59% of people aged between 50 and 64 with DC plans have never thought about the number of years in retirement that they need to be able to finance. Crawford, R. and Tetlow, G. (2012), 'Expectations and Experience of Retirement in Defined Contribution Pensions: a Study of Older People in England', IFS Report, November.

<sup>6</sup> Longevity risk is the risk that a pension plan will have to provide benefits to its members over a longer period than expected. On longevity risk and pensions, see Madsen, C. and Tans, M. (2011), 'Longevity and Pensions', AEGON Global Pensions White Paper. On the adequacy of pension saving in the UK, see, for example, Office for National Statistics (2012), 'Pension Trends', chapter 8, 'Pension Contributions', p. 7.

<sup>7</sup> CDC pension plans were introduced in the Netherlands at the beginning of the 21st century. In the period 2004–05, several large Dutch single-employer pension funds made the transition to a CDC pension plan. Among them were Akzo Nobel, SNS Reaal, VolkerWessels and Arcadis. Later, the railway transport sector pension plan and ING followed.

<sup>8</sup> The option of reducing the accrued pension rights is available only for a pension fund. An insurance company can never reduce accrued pension rights.

<sup>9</sup> The Dutch pension agreement describes the DA pension contract as one in which 'the obligations are defined in real terms and are completely flexible...these real obligations are, as a whole, variable and therefore respond more quickly to changes on the financial markets'. Stichting van de Arbeid (2010), 'Pensioenakkoord Voorjaar 1010', June 4th (translated by T. Robinson and E. Schouten).

<sup>10</sup> Communication on pensions is required to be clear and accurate. Pensions also have to be reported in a standardised fashion so that individuals are able to compare pensions built up with different employers. This is achieved through the Uniform Pension Overview (Uniform Pensioen Overzicht, or UPO).

<sup>11</sup> See, for example, Heemskerk, M. and Minnaard, M. (2011), 'Impasse Pensioenakkoord door Juridische Belemmeringen: Invaren een Zinkend Schip?', *Pensioen Magazine*, 5. This would be a breach of Article 1: First Protocol of the European Convention on Human Rights.

<sup>12</sup> Ministerie van Sociale Zaken en Werkgelegenheid (2012), 'Hoofddlijnnnota Herziening Financieel Toetsingskader Pensioenen', Tweede Kamer, vergaderjaar 2011–2012, 32 043, nr. 113, appendix 2.

<sup>13</sup> A 2010 report estimated that members of Dutch CDC plans who made the same contributions as their UK counterparts with individual DC plans would end up with 50% more pension. Although the headline amount (and the type of comparison made) may be exaggerated, the advantages of economies of scale and investment strategies that CDC enables are valid. CDC, however, is not the only way to benefit from such economies of scale. See Pitt-Watson, D. (2010), 'Tomorrow's Investor: Building the Consensus for a People's Pension in Britain', RSA Projects, December.

<sup>14</sup> Employee commitment is demonstrated by a willingness to perform additional work above and beyond normal duties. See Green, M. and Robinson, T. (2012), 'Expatriate Pensions and Employee Commitment', AEGON Global Pensions White Paper, p. 9.

If you have any questions regarding the issues raised in this article, please contact the editor,  
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