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Balancing the Security and Affordability of Funded Pension Schemes

Short Report

On behalf of the
European Commission
DG Employment, Social Affairs and Inclusion

Peer Review: Balancing the Security and Affordability of Funded Pension Schemes

The Peer Review was held in The Hague, the Netherlands on 12-13 April 2011 to discuss how to balance funded pension schemes to ensure that they offer both security and are affordable. It was hosted by the Dutch Ministry of Social Affairs and Employment.

Joining the host country, the Netherlands, to discuss the Dutch funded pension schemes and offer insights from their own systems were government representatives and experts from nine peer countries: Belgium, Denmark, Germany, Ireland, Italy, Lithuania, Poland, Romania and Slovenia. They were joined by the thematic expert from Sweden, the network expert from the Netherlands, and stakeholders from AGE Platform Europe and the European Federation of Retirement Provision (EFRP). There were four representatives from the European Commission's Directorate General on Employment, Social Affairs, and Inclusion: Active Ageing, Pensions, Healthcare, Social Services, who all contributed to the review.

1. The policy under review

This review was designed to provide insights into whether the Dutch pension system, in particular its supplementary occupational pension (Pillar 2), is sustainable in the light of the Netherlands' ageing population, falling birth rate and the global financial crisis. As people are living longer, want pensions to be secure and do not want to pay very high taxes and contributions, what is the best way to balance costs and benefits?

Background

In 2010 the European Commission launched its Green Paper on Pensions to instigate a debate on the future of adequate and sustainable pensions in Europe. It highlighted how pension systems across the EU are changing, with many moving from largely a single pillar payg ('pay as you go') system, to a multi-pillar or hybrid system, which brings together the public and private sectors with an increased role for private-funded pensions. However, as these are dependent on the volatility of financial markets many have been affected by the financial crisis.

The Netherlands has one of the best pension systems in the world, and, one of the lowest at-risk-of-poverty rates for old people in the EU. It is an example of a system which combines public and private pension provision. It has three elements:

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- 'Pillar One': a state pension (OAW) often described as a 'Pay As You Go' system, that provides all Dutch retirees with an income equivalent to 50% of the minimum wage for each partner in a couple or 70% for a single person. It is index-linked to the minimum wage, and financed through tax revenues and pay-roll taxes.

- 'Pillar Two': occupational pension schemes, which are capital funded. These are either company-specific, or sector-based (e.g. teachers), and are designed to supplement the OAW so that pension income matches 70%-80% of the average salary. They are the result of negotiations between the social partners (employers and unions) and thanks to the wide coverage of collective agreements and supporting legislation they are almost mandatory in the sense that they form part of the labour contract for more than 90% of those in employment. At present most of the contributions are shared between employer and employees. Contributions and investment returns are tax-exempt while benefits are taxed.

- ‘Pillar Three’: individual pension schemes, financed through annuity insurance.

2. Key issues

During the presentations and discussions, which focused principally on occupational pension schemes, the following key issues emerged:

Recent threats to the pension system

Over the last decade, pensions, in particular occupational pensions, have come under threat from a number of developments:

- The ageing of the population – the combination of longer-life expectancy and an unchanged retirement age has made it far more expensive to finance pensions.
- The low birth rate means that there will be fewer workers in the future to finance pensions.
- Pension funds are ‘ageing giants’. More than 60% of total assets are earmarked for pensions that have already started, or will start in the next ten years, which does not leave much room to adjust to shocks through higher contributions.
- Occupational pensions experienced considerable losses in the value of their assets during the financial crisis, solvency rates in the Netherlands falling from 130% to less than 105% between 2007 and 2009.

Current challenges

- As a result of these threats, pension funds have changed their investment strategy since the early 1990's. They have been moving from investing in government bonds, which bring a regular, stable, but not very high income, to equities, which bring higher returns, but are not as predictable and depend on the up-and-downs of the money-markets.
- ‘Risky behaviour from some pension funds have put pensions and individuals at considerable risk and led to a drop in confidence and rising fears about investing in funded pensions.
- Individuals are unaware of, or tend to be rather disinterested in, the status of their pensions.

Planning for the future

- The financial crisis has highlighted the need to review the levels of dependence on the financial markets and to plan to absorb potential financial shocks.
- There is a need to achieve a better balance for pension savers and providers between risks, security and returns, to restore trust and raise public awareness about the need for long-term savings to ensure a secure old age.
- The crisis in the pension systems has raised the question of how far it is still possible to base pensions on the principles of ‘solidarity’ between generations, whereby younger generations support older generations, and will later be supported themselves.

3. Lessons learnt and recommendations

Among the points that arose from the review:

How to ensure the sustainability of the Dutch pension system

The following were suggested:

- The Dutch are justifiably proud of their pension system, but is it possible for them to retain ‘their darlings’ - i.e. principle of inter-generational solidarity and collective security, under the present strained circumstances? Perhaps it is more realistic to expect younger workers to support older pensioners unconditionally, than for younger pensioners to share the risks?
- To make pensions more sustainable, the Dutch need to continue to move from a defined benefit (DB) system: where individuals know how much they will receive, to a defined contribution (DC) system: where individuals know how much they pay, but the benefits depend on the vagaries of the market. To have the opportunity to get better returns and thus make pensions more affordable people will have to accept more risk and less security of their pension income over time.
- Drop the index-linked nature of pensions to wages to make them less costly.
- Introduce labour market policies for older workers that encourage them to be more mobile, receive training, develop age-conscious staff policies, and use incentives to encourage employers and employees to see the benefits of older workers.
- Reduce the number of occupational pension funds from the current 650 to a much smaller number. This would bring economies of scale, making pension funds and insurance companies more efficient and able to offer better rates of return.

The transferability of the Dutch system to other countries

- The Dutch system is admired for its high coverage and principle of preventing poverty in old age and it offers itself as a possible role model for countries that would like to develop a large role for pre-funded occupational pensions and a co-responsibility of the social partners for pension provision. But are many other countries able or prepared to allocate such a high level of national resources to social protection, and would it bring them sufficient long-term benefits?

- In considering the possibilities of adopting similar schemes in other countries, one must analyse the national capacities and also assess how countries define equity and sustainability.

Improve education, awareness and transparency

- The public appears almost impervious to measures to educate them about their pensions, despite inventive methods by companies like APB in the Netherlands. This raises the issue of whether people should be expected to take a high level of interest and how proactive they need to be in choosing schemes? There may be narrow limits to what one can expect in as much as people are myopic and rarely think about their pensions before they are in their 50's. Still recent Dutch debates demonstrate that people can be mobilised to take a much more active interest in the issue when suddenly their expectations may be threatened.

- Improve the transparency about the governance of pension schemes. This will help restore consumer confidence and trust in pension funds and insurance companies.

- Make pension funds more transparent about the risks of pensions which depend on the money market. The public needs to be aware that it rarely is possible to achieve both a high rate of return and water-tight guarantees for stable level of benefits.

- Provide public education about pension ‘payouts’: some funded systems give a lump sum on retirement. The individual then has to make a decision about where to place this, a process which can be open to unscrupulous companies.

Role of the social partners

- Giving the social partners a large role in the management and design of schemes was praised, but it appears that some employers may be reneging on their responsibility to provide occupational pensions and are persuading their workforce to move to individual pensions (Pillar Three). This transfers the risks from employers to employees.

- More generally, the increasing costs of the occupational defined benefit scheme cannot be covered by reducing gross earnings by raising employee contributions even more. This means that plans will evolve into “stand alone” plans. In this context it will become important to determine how risks should be shared among workers and pensioners.

Adapt pensions to circumstances and needs

- Occupational pensions need to be adapted to female working patterns. Many women cannot make consistent payments as they take breaks from their working life to raise children or work part-time to care for dependent relatives. Countries that provide compensation within the pension system usually do this through general revenue financed transfers during the accumulation period. This is more straight-forward in DC plans, where money can simply be transferred to individual accounts. The Netherlands will have to think carefully about the practicalities of doing this in a DB format.

- Pensions should be more flexible to individual retirement patterns. Some workers want to continue working fulltime, some part-time, and others to stop working altogether, where it should be possible to continue to work full or part-time and receive a (partial or full) pension at the same time. Even here individual account plans make this much easier since the direct link between contributions and benefits means that additional contributions always lead to commensurately higher benefits.

The European context

- With the European Internal Market, funded pensions are no longer just dependent on national markets, so risks are diversified with more collective security in a broader market. Funded pensions also stimulate the Internal Market.