Netherlands: Macroeconomic challenges to occupational pension reform

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Occupational pension schemes have been the target of reform for more than ten years in the Netherlands. The government and social partners agreed a new system in June 2019, and legislative passage is scheduled for late 2022. The current system is based on capital-funded, defined benefit pension contracts linked to employment. The proposed reform will introduce defined contribution pension contracts where individuals bear more risks. Rapidly changing macroeconomic conditions, mainly higher interest rates, are likely to complicate the final stages of the reform process.

Description

The Dutch system is a multi-pillar system which relies on: i) a flat-rate "pay-as-you-go" statutory public scheme (AOW); ii) occupational pension schemes, which are funded by tax deductible contributions by employees (one third) and employers (two thirds) that provide about half of retirement income; and iii) private pension schemes.

Occupational pension schemes cover 80% of employees. They are collectively organised and quasi-mandatory, and may be linked to individual firms, sectors or professions. Even though capitalisation is very high (assets were €1.68 trillion at the end of 2020), the global financial crisis, persistently low interest rates (until spring 2022), and rising life expectancy have undermined the financial solvency of many schemes, prompting calls for reform. After a decade of negotiations, government and social partners reached a draft Pension Agreement in June 2019.

The current regulatory framework requires occupational pension schemes to have financial assets sufficient to cover future pension payments for all participants. Here, the coverage ratio (i.e. the ratio of the value of financial assets to the estimated cost of future pension payments) is crucial. Most occupational pension schemes currently provide defined benefit (DB) pension contracts based on capital funding. Pension schemes are required to calculate the present value of current and future pension payments using current interest rates and to have assets under management that equal or exceed the value of these pension promises. As interest rates increase, the value of accumulated future pension payments decreases, so pension schemes need fewer financial reserves to meet their pension obligations.

If a pension scheme's coverage ratio dips below 104%, it must take remedial measures (contribution hikes; benefit freezes/cuts) to restore solvency within ten years. Importantly, the indexation of both accrual and benefits is conditional on pension fund solvency. Schemes may index current and estimated future payments if their coverage ratio is at least 110%. The effects of these solvency regulations mean that pension accrual and pension pay-outs have been frozen until recently for most workers and pensioners since 2008. For example, public sector workers have lost 19.95% in indexation (annual adjustment of pension levels to wage growth and/or inflation) between 2009 and 2022 (ABP 2022). Pension contribution rates have also increased for most workers.

The draft pension law aims to prevent the deterioration in pension rights by keeping some collective elements, while giving pension schemes more flexibility to respond to macroeconomic changes (interest rates, financial market fluctuations) and demographic shifts. The current government (Rutte IV, in place since January 2022) introduced legislation on 30 March 2022 that will replace DB schemes with a more flexible pension contract that gives pension funds more flexibility to respond to fluctuations in the coverage ratio (Rijksoverheid 2022). The reform would introduce two types of pension contracts: a collective defined contribution (DC) variant and a more individualised DC option. The collective DC variant resembles current DB plans in that pension schemes will invest pension contributions collectively on behalf of members, and there will be a buffer fund to respond to macroeconomic fluctuations. In contrast to existing policy, however, participants will have individual pension accounts to which investment returns are allocated. Legislative passage is expected in late 2022 with effect on 1 January 2023. Implementation is planned for 2023 to 2027.

Outlook and commentary

The planned reorganisation of the pension system would mean the most far-reaching reform of the social security system ever because it entails transferring collectively-managed pension assets (about €1.5 trillion, or two times annual GDP) to 10 million individual DC pension accounts.

The Pension Agreement was negotiated against the backdrop of low interest rates and robust financial markets. The rapid increase in interest rates in 2022 coupled with a financial market downturn, has prompted key political actors to try to postpone the reform and/or seek modifications. Rising interest rates reduce the estimated cost of future pension payments, improving many pension funds' coverage ratios and allowing them to index pension accrual and pay-outs. The spike in interest rates during a period of financial market uncertainty means that some of the largest pension schemes have seen the value of their financial investments drop, and yet they have been able to uprate, or "index" current and future pensions to inflation or wage developments, depending on scheme rules. At the end of June 2022, the occupational pension sector had a combined coverage ratio of 122.4%, up nearly four percentage points in three months, and about 13 percentage points compared to one year ago (DNB 2022).

The experience of the largest pension fund (for employees in the government and education sectors [Algemeen Burgerlijk Pensioenfonds, ABP]; €500 billion in assets) is instructive. ABP announced inflation indexation of 2.39% starting in July 2022, with an additional 1.2% to pensioners. This is the first increase in pensions in more than ten years.

Political decisions have also facilitated pension indexation. In the first half of 2022, the government relaxed indexation rules by decreasing the minimum coverage ratio required for indexation from 110% to 105%. Besides ABP, pension funds PME (for metal/electro-manufacturing industry) and PWRI (for work and (re)integration) increased pensions by 1.29% and 1.87%, respectively, on 1 July, because of the new rules.

As many workers and pensioners experience the first pension increases since 2008, they have begun to question the key features of the proposed system, particularly the shift of more risk onto individuals that would result from the shift to a DC system. Importantly, the expert analysis underpinning the reform did not consider the effects of rising inflation. There is also growing concern about the reform's complexity because of the daunting task of calculating how to allocate € 1.5 trillion to individual accounts.

These concerns caused heated and lengthy debate in Parliament in September. The reform rests on a compromise between six parties: the four governing parties (Liberals, VVD; Social Liberals, D66; Christian Democrats, CDA; Christian Union, CU), the Green-Left (GL) and Labour (PvdA). The governing parties remain committed to reform, while GL and PvdA have raised concerns. A key issue concerns the timing and procedure for transferring collectively-held pension assets into individual accounts. Timing is crucial because financial asset values fluctuate and financial markets are currently generating losses (pension assets were €1.8 billion in January and have fallen to €1.5 trillion in September), so it is impossible to forecast the value of individual pension accounts until the transfer occurs. Moreover, pension funds have begun to index pension pay-outs and accrual, prompting concern that the new individual pension accounts will not be sufficient to finance current pension pay-outs. GL and PvdA are pushing for concessions concerning the transition to individual accounts, including detailed guarantees about how the allocation of capital into individual accounts will be "balanced" across groups, as well as limits on potential losses. The Pensions Minister has responded with pledges to cap losses for individuals at 5%.

Rising energy costs and slower economic growth in the second half of 2022 will no doubt further complicate the current government's efforts to secure final passage of the pension reform. Younger generations have long claimed that the pension system disadvantages them by requiring all age and income groups to pay the same contribution rate. Current pensioners rightly point out that that their occupational pensions have been frozen since 2008. And current workers point to the higher contribution rates and often lower accrual rates they are subject to. These distributional conflicts are likely to re-emerge in the context of recession and inflation. Before the onset of high inflation and financial market uncertainty in 2022, politicians could claim that the reformed pension system would benefit all groups. The rapidly changing macroeconomic context has called this into question.

Further reading

ABP (2022) Indexatie: verhoging pensioenen [*Indexation: Increase in pensions*]

DNB (2022) Dutch pension funds' average funding ratio improved

Rijksoverheid (2022) Wetsvoorstel wijziging Wet toekomst pensioenen [*Law Proposal on changes to the Law on the future pension system*] (Kamerstuk. 30 maart 2022 [*Parliamentary papers, 30 March 2022*]).

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