THE DUTCH EXPERIENCE WITH DEFINED AMBITION PENSIONS AND WHAT THAT MAY MEAN FOR COMPANIES IN THE NETHERLANDS AND THE UK

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In the Netherlands, Defined Ambition (DA) pensions are being introduced in order to help relieve the pressure on employers while still trying to provide employees with a more secure pension. The UK too is looking at DA pensions as a solution. What are DA pensions and what will they mean for companies?

The decline of DB pensions

Good pensions increase employee commitment.[1] From an employee point of view, a good pension is one that will pay an adequate – and predictable – stream of income in retirement (until death). However, from an employer's point of view, providing such a pension has become increasingly difficult and costly. Accountancy, increasing regulation and the financial crisis have transformed the way companies manage their pensions, and companies are derisking their defined benefit (DB) plans and moving to defined contribution (DC) plans.[2]

Pension pressures in the Netherlands

The Netherlands, like many other countries, is facing the economic consequences of ageing populations. As a result, the retirement age for occupational pensions is being increased to 67 in 2014 and will be linked to life expectancy thereafter. In addition, the government is reducing fiscal support for pensions during the accumulation period. The present Liberal (VVD)/Labour (PvdA) cabinet plans to further reduce fiscal support for pensions in 2015 with tax-free pension accrual capped at a retirement income of €100,000.

In the Netherlands, however, second pillar or occupational pensions are the exclusive domain of the social partners (employers and employee associations, including trade unions). Reducing the maximum level of tax advantages for occupational pensions and increasing the retirement age does not therefore result in automatic changes to pension entitlements but rather leads to renegotiations between employers and employees on the adjustment of existing pension arrangements. When tax law is changed in such a way that individuals will only receive the same pension rights as currently

[1] Recent research by AEGON (in which 9,000 employees in 9 countries were interviewed) showed roughly a 12% increase in commitment from employees who were confident about their retirement. See Green, M. and Robinson, T. 2012 *Expatriate pensions and employee commitment* (AEGON Global Pensions white paper), p.10.
[2] "Pensions in Europe, How multinational companies are preparing their pensions in Europe for the future", AEGON Global Pensions, November 2011. http://www.aegonglobalpensions.com/en/Home/Publications/Research-papers/Pensions-in-Europe/

promised at the age of 65 if they work for two years longer, it is likely that employees will look to their employers to share some of the pain.

In the meantime, pension funds in the Netherlands are also feeling the consequences of low interest rates and rising life expectancies. In 2013, around 70 Dutch pension funds will have to reduce pay-outs, and 40 will have to make further cuts in 2014. The cuts will affect some 3.1 million pensions, including 0.7 million people who have already retired. According to the Dutch Central Bank (DNB), the average pension reduction will be around 1.9%.

Transferring risk

Although DC pensions may be a cause of relief to employers, they achieve this by transferring risks to employees – risks that employees often do not understand and may not be able to deal with.[3] The consequences of this transfer are not hard to see – most employees in the UK with DC pensions are presently saving too little for retirement and have little concept of the consequences of longevity risk.[4] It is clear that employees require assistance. One of the proposals put forward (in a number of different guises) has been Defined Ambition pensions.

Employers are looking for predictable pension costs; employees are looking for predictable pension outcomes. Defined Ambition 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 keep) the idea of an employer bearing some risk on behalf of their employees. However, there are presently 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 Defined Ambition pension (as being implemented in the Netherlands) can perhaps best be described as DA from DB (DA/DB). It is a modification of the DB pension system in which a pension fund continues to operate as before but that instead of making a hard promise to provide a pension based on average career salary, the employer makes a promise to target a specific pension based on average career salary. But 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, the employer 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 Defined Ambition 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 2012 UK Department of Works and

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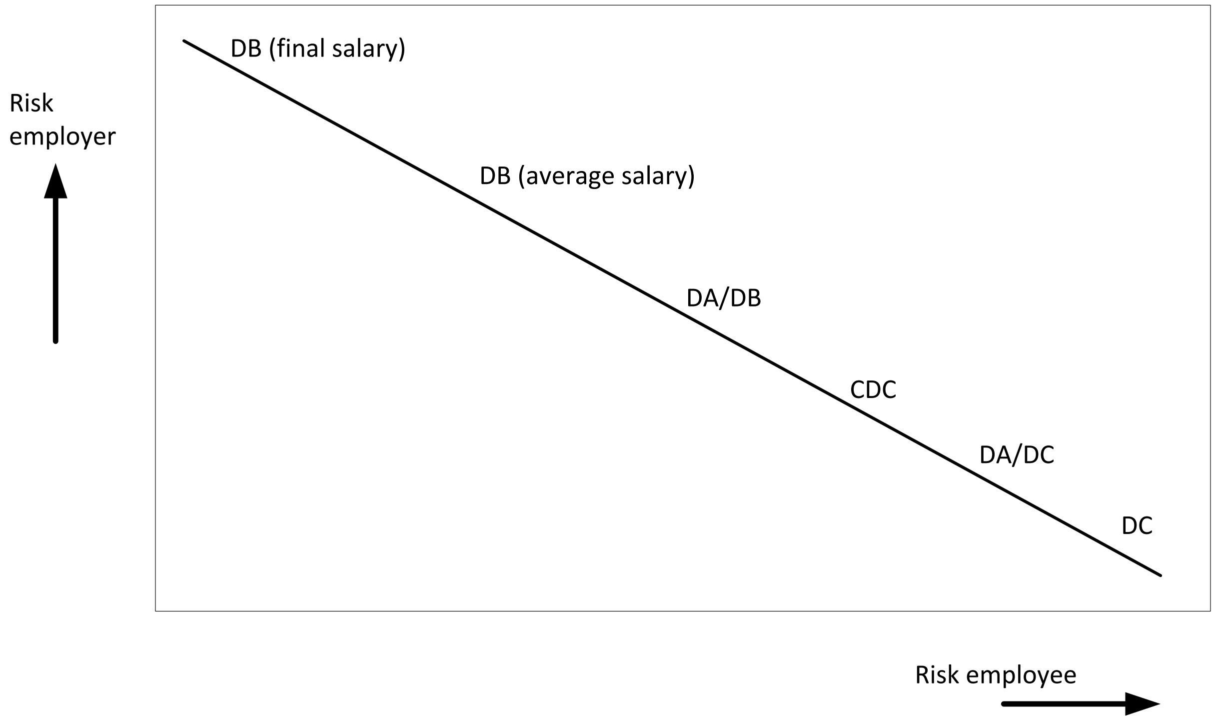
[3] For example, a recently published survey by the UK Institute for Fiscal Studies revealed that 59% of people aged between 50 and 64 with DC plans have never thought about the number of years in retirement that they need to be able to finance (Crawford, R. and Tetlow, G. November 2012: *Expectations and experience of retirement in Defined Contribution pensions: a study of older people in England* (IFS Report).
[4] See, for example, Office for National Statistics, **http://www.ons.gov.uk/ons/rel/pensions/pension-trends/chapter-8--pension-contributions--2012-edition-/index.html p.7**.

Pensions (DWP) strategy paper provides a list of possible 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 employee's funds through annual or terminal bonuses (a sort of partial CDC). CDC itself is not presently possible in the UK, but some forms of DA/DC pensions, such as the Cash Balance pension provided by Morrisons to its employees, are in use today.

Differences in risk profiles of various pension systems



From DB to DA in the Netherlands

If we look at the Dutch pension system, it is necessary to make a distinction between insurance companies and pension funds. Dutch DB pensions as provided by pension funds would today already be recognised as DA pensions according to the DWP's categorisation. Dutch DB plans already offer partially conditional, non-indexed pensions (hence the rights cuts that many Dutch pensioners and savers are presently experiencing). 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[5]. However, rising costs and the volatility of pension liabilities has led to the creation of new pension contract, the legislation for which is expected in 2014. The Dutch minister wants pension funds to develop a mechanism for the automatic adjustment of pension rights, benefits and targeted retirement age in line with life expectancy. This mechanism, once approved, would become mandatory for DA pension contracts but could also be applied to indexation under the existing nominal DB contracts.

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 which will fix employer contributions at the present level. Among the key points of the proposals are mandatory

[5] According to Dutch pension law, only pension funds can reduce pensions, Insurance companies are not permitted to do so under any circumstances.

agreements between the social partners and the pension funds about sharing financial risks between older and younger generations. New rules must also ensure proper and uniform communication.

What about accrued pension rights?

One of the biggest issues now with the move to DA in the Netherlands is how to deal with accrued pension rights. In the Netherlands, for the new Dutch pension agreement to be successful, a transfer of accrued pension rights is necessary. As a result of rising longevity and the developments on the financial markets, continuation of the existing nominal pension contract is no longer affordable. Without bringing the accrued pension rights under the force of the new rules, it would take decades before the advantages of the new pension contract would be achieved.

Even though a mandatory transfer of accrued pension rights is a violation of the right of ownership of participants of the pension fund and retirees, the Ministry has stated that it believes it can be justified by the public interest, as it will make occupational pension plans sustainable. The mandatory transfer is required in order to maintain solidarity between young and old by means of risk sharing in the pension fund.

Moving to DA in the Netherlands – a timetable for change

In order to make DA pensions possible in the Netherlands, the supervisory regulations will have to be changed. The new rules are planned to be set into legislation in 2015. Before that moment, pension funds will not be able to switch to DA pensions. However, this does not mean that nothing is happening. The Dutch ministry of Social Affairs is presently working with a few major pension funds (including the largest pension funds in the Netherlands) on a pilot project on the mandatory transfer of accrued pension rights to the new DA pension. Although other companies will have to wait a little longer if they wish to change their DB pension plan into a DA pension plan, they will be able to follow closely the implementation path being taken by the funds involved in the pilot project.

In the meantime, the latest round of pension reform in the Netherlands will be keeping companies busy in the Netherlands. Due to the raised retirement age and the reduction of fiscal support, many companies in the Netherlands will have to make significant changes to their pension plans this year. Employees will have to agree to the changes and the changes will have to be finalised before 1 January 2014, at which time the new fiscal rules will apply and all pension plans will have to be compliant. Research shows that approximately 50% of Dutch pension plans will need to be changed in 2013. The other 50% are not presently using the maximum fiscal allowance, which means they can absorb the fiscal reductions without having to change their pension plan.

Can DA play a role in the UK?

For most employers in the UK, it is clear that the risk and burden of providing Defined Benefit (DB) pensions has simply become too great. Far more than in the Netherlands, companies in the UK have overwhelmingly moved towards providing Defined Contribution (DC) pensions. 54% of companies in the UK now provide DC pensions only, with a further 41% of companies in transition.[6]

If companies are unable to transfer accrued DB pension rights into DA pension rights, it seems less likely that many will choose to move from DB pensions to DA/DB pensions. The majority of

[6] Association of Consulting Actuaries *2011 Pension Trends Report*, fig. 4, p.10.

companies in the UK have already made the shift to DC pensions, so a DA/DC pension seems like 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.[7] However, the paper appears in advance to indicate that introducing CDC to the UK would be difficult and that CDC depends on economies of scale to be effective. Once again, the Dutch experience could be beneficial, as there are hybrid CDC plans in existence, where 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 elements, such as guaranteed funds are also provided in the Netherlands, although as in the UK, guaranteed funds might provide an element of security and certainty but this 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 to their employers.[8] Providing them with a pension that will increase their optimism about retirement (and thereby increase their commitment) may prove beneficial both to employers and employees.

DA pensions in a DC world do not so much require any single specific mechanism (as the wide 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 they wish to make and at how willing they are to assist their employees to achieve an adequate income in retirement.

The DWP 2012 paper provides something of a ‘shopping list’ for DA pensions, and may leave some more confused than enlightened. However, it will hopefully provide companies and consultants with food for thought for creating new DC plans that will provide employees with more certainty about their retirement – 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 soon-to-be-introduced DA/DB pensions) may help both companies and the government in the UK to explore some new ideas on how to design a sustainable and effective occupational pension system for the future. And for those companies with pension plans in the Netherlands, the next two years will be busy years, as pension arrangements will have to be redesigned and renegotiated. For the Netherlands at least, DA pensions are on the horizon.

[7] 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 Tomorrow's Investor: Building the consensus for a People's Pension in Britain, David Pitt-Watson.
[8] See Green, M. and Robinson, T. 2012 *Expatriate pensions and employee commitment* (AEGON Global Pensions white paper), p. 9.