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Dutch pension cuts imminent

Rabobank

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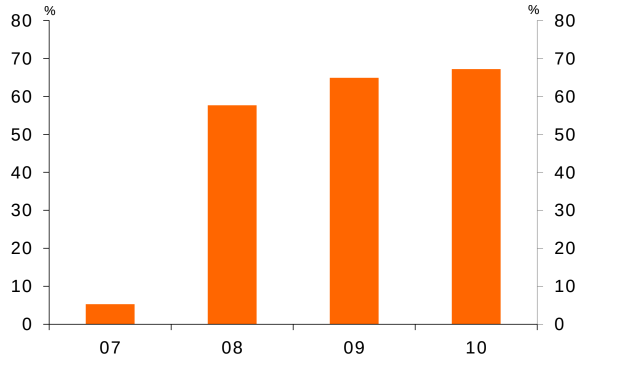
Three of the largest Dutch pension funds have recently announced that pay-out cuts are imminent. One of the affected funds, ABP, is starting talks today about the exact percentage by which pay-outs should be lowered. Two weeks ago ABP already said that “a cut in the pensions of current pensioners, as well as the pension rights of those people still working, of 0.5% per 1 April 2013 has now become a real option”. ABP is the pension fund for employees in service of the Dutch government and educational sector. It is the largest Dutch pension fund with 2.8 million members and assets totaling €246 billion. ABP’s funding ratio amounted to 94% at end-2011. The funding ratio on 31 December 2012 will be used to decide whether the pension cut will actually enter into force by 1 April 2013. ABP is also going to raise the recovery surcharge on the regular pension premium from 1 to 3%. This will entail an additional €1 billion cost to the Dutch government, which – being the employer of ABP’s members – has to contribute 70% of the pension premium.
Metal workers’ pension funds PME and PMT recently announced even more sweeping pension cuts. The two funds, with a total of 1.9 million members and €66.7 billion of assets, have funding ratios of 90% (PME) and 88.5% (PMT). If the funding ratios are insufficiently recovered by end-2012, funds are facing pension cuts of 6-7%. A definitive decision about pension changes will be made mid-February and the lower pension would enter into force by 1 April 2013.

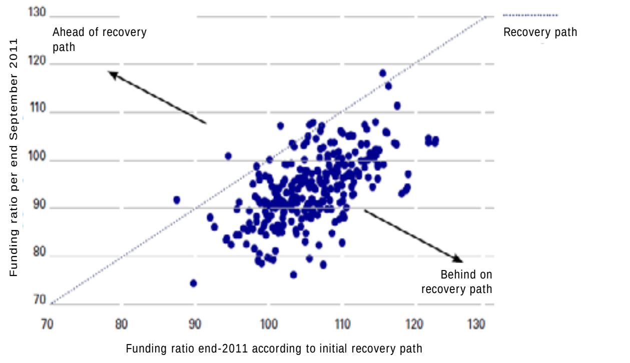
The pension cuts can be attributed to insufficient recovery of financial markets, low interest rates and increasing life expectancy. The financial market crisis that followed on the 2008 Lehman default pushed many Dutch pension funds into a state of underfunding (implying that the funding ratio drops below 100%). From a regulatory perspective funds are required to maintain a minimum funding ratio of 105%. The funds that no longer complied were required to issue a recovery plan with the regulator. Figure 1 shows the percentage of pension funds with a recovery plan per year. Given the severity of the crisis the regulator allowed funds to recover over a period of 5 years (instead of the usual 3 years).

Figure 1: Pension funds with a recovery plan



Source: DNB

Figure 2: Many funds are behind schedule*



Source: DNB

*The figure shows the reported funding ratio of pension funds with a recovery plan at end September 2011 in relation to the funding ratio that has to be realized end-2011 according to their recovery plan.

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For many funds this implies that the funding ratio has to reach 105% by 1 April 2013. Directly after the financial crisis funds seemed to stick to their recovery path quite well as stock markets bounced back over the course of 2009. In 2010, however, things turned around and markets are only very recently showing signs of recovery again.

More significant from a pension fund perspective, however, are the historically low interest rates. The regulatory framework in the Netherlands requires pension funds to discount liabilities by Euro swap rates, implying that low interest rates translate into a lower funding ratio. The lingering Eurozone crisis has pushed interest rates down (as capital flees to safe-havens such as the German bund), which has a significant adverse effect on the financial condition of pension funds. A vast majority of funds which are in recovery, including the above mentioned ABP, PME and PMT, are now falling behind on their initial recovery path (see Figure 2). Many of them will have to resort to pension cuts to tilt their funding ratio back to sustainable levels. For pension fund members this measure comes in addition to a cumulative loss of inflation indexation of approximately 8% over the past three years. Many pension funds are currently strongly advocating the use of a more smoothed measure of the discount rate, for instance a yearly average of the term structure of interest rates. DNB has already allowed funds to use the three-month average of the interest rate to discount liabilities for end-2011, which provides some relief but most likely not enough to prevent pension cuts. A third reason why the funding ratios have not sufficiently recovered is the unexpected increase in life expectancy. As pension fund members live longer than was anticipated, pension funds have to accumulate additional reserves to cope with the extended average length of pay-outs.

Meanwhile pension funds' implicit target of providing inflation indexation to their members seems to be a long way out of sight. A nominal funding ratio of around 130% is required for pension funds to provide inflation indexation. Under the current rules this would imply that pension fund members have to miss out on indexation for the next five years or so. Yet there seems to be one escape route. Last year Dutch employer organizations and labour unions reached a new pension agreement which is going to re-shape the pension system in a way that risk becomes an explicit part of the pension contract. In return pension funds are allowed to discount liabilities by the long term expected portfolio returns rather than the risk-free rate. This obviously has a positive influence on the funding ratio. Furthermore, the 25% buffer requirement that pension funds currently face will be dropped, implying that indexation is possible when the funding ratio reaches the minimum regulatory level of 105%. Employers and labour unions initially targeted 1 January 2013 as starting date of the new agreement, but people working in the pension field think 2014 is the more realistic date. The only way to avoid the pension cuts scheduled for 2013 would be some kind of transition agreement which incorporates some of the principles of the new pension agreement. The Dutch Ministry of Social Affairs and Employment is currently contemplating such an arrangement.

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