Special Report 2011/09

Pension agreement for the future?

A year after signing the agreement in principle on the future of the Dutch pension system, the social partners approved the final draft of the pension agreement on 9 June 2011. Reform of the Dutch pension system is inescapable.The Dutch population is ageing rapidly and as a result state pensions are in danger of becoming unaffordable. What's more, the funding ratios of pension funds fell during the financial crisis. But does the Dutch pension agreement constitute the long-awaited panacea?

The Dutch pension system

The Dutch pension system consists of three pillars: (1) a flat-rate state pension (*AOW*), (2) a funded occupational pension and (3) private pension savings. The Dutch state pension (*AOW*) benefit is financed on a pay-as-you-go basis (current workers pay for the pensions of current retirees). The state pension provides a basic income, the level of which is linked to the statutory minimum wage. The second pillar is financed by capital funding. This means that the pensions benefits are financed by pension contributions paid in the past and investment returns on these contributions.

A unique characteristic of Dutch occupational pension arrangements is that they are negotiated in a tri-partite cooperation between employers' organizations, labour unions, and the government. This tri-partite setting is similarly used for negotiating other labour conditions and wage bargaining. It is popularly known as the 'poldermodel'. Pension arrangements are included in the collective labour agreements (*CAOs*), which are negotiated between employers' organizations and labour unions per company and per business sector. These *CAOs* are usually declared universally binding by law. As a result, virtually all (94%) employees are covered by a quasi-mandatory second-pillar pension plan. Compared to other OECD countries the Dutch occupational pension reserves are one of the largest in per capita terms. They are the backbone of the old-age pension system.

Why a new agreement is inevitable

There are two underlying causes why a new Dutch pension agreement is crucial: the ageing population that is placing the current state pensions at risk of becoming unaffordable and the low funding ratios of pension funds. The first places the government budget under pressure, while the second is the result of the financial crisis, low interest rates and rapidly rising life expectancies.

State pensions unaffordable

An ageing population with a smaller labour force represents a growing problem for the Dutch government. Government spending on state pensions and healthcare is increasing, while the basis for financing services for seniors is shrinking. Without a change in policy, spending on state pensions will double from € 27 billion currently to approximately € 50 billion in 2040 (CPB, 2010). Considering that the annual required costs of the state pensions are distributed among the total working population in that year, an increasingly smaller number of working people must pay more taxes per person.

Rising healthcare costs come on top of this. Higher tax receipts on state pension payments and consumption of over-65s can only compensate for roughly half of the increase in state pension and healthcare spending. The unsecured account for the future consequently constitutes the main problem relating to Dutch government finances. The CPB Netherlands Bureau for Economic Policy Analysis estimates the sustainability gap[1] at 4.5% of GDP.

[1] The sustainability gap is the difference between the actual forecast 2015 budget balance (the starting point for the CPB's calculations) and the budget balance whereby the government finances would be

Perils in the second pillar

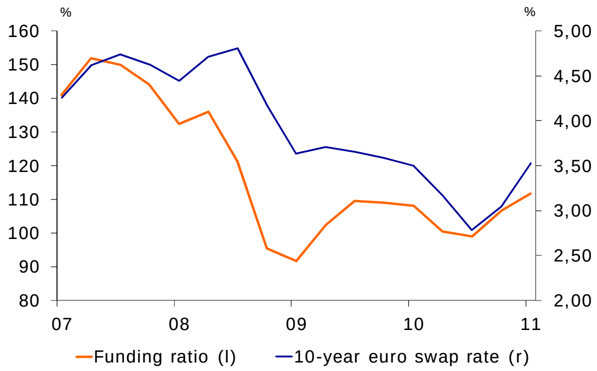
The funding ratios of pension funds – the ratio of assets and liabilities – ran into trouble during the credit crisis. While the total funding ratio of pension funds still amounted to more than 150% in the third quarter of 2007, it dropped to 92% in the first quarter of 2009 (figure 1). Decreasing numbers of premium payers make it increasingly difficult for pension funds to absorb disappointing investment results by charging higher premiums. Pension funds' distressed financial position is, however, primarily attributable to the trend of falling long-term interest rates, which has led to an increase in the market value of the future pension obligations.[2] The unexpectedly strong rise in life expectancy is furthermore creating a continuing increase in pension obligations.
The fall in the funding ratios meant that many pension funds were no longer able to let the pension payments grow in tandem with inflation or the average wage trend. A number of funds have even cut the nominal pensions.
Pension funds find themselves in an impossible predicament of having to try to guarantee nominal pension rights and index pensions at the same time. The current low funding ratio is, however, insufficient for being able to achieve both aims.[3] The pension system as a whole is in danger of becoming untenable in its current form. This is why it is necessary to attain a new pension agreement that establishes the rights and obligations of pension fund participants much more explicitly.

tenable. Sustainability in this context means that all future government income will be sufficient to pay for future expenditures, including the interest on the existing debt.

[2] The value of future obligations of pension funds is, for accounting reasons, always converted to the present value using a so-called discount rate. Because the majority of the pension funds' obligations lie in the future, the gross of the obligations are discounted against the long-term interest rate.

[3] The calculation of the funding ratio is based on the ability to pay a nominal pension that is not adjusted for inflation. According to the CPB (2010), a funding ratio of approximately 145% is required in order to pay the indexation of pensions. The total funding ratio amounted to 112% in the first quarter of 2011.

Figure 1: Funding ratio of pension funds



Source: De Nederlandsche Bank (Dutch Central Bank)

Polder deal for the future?

It has been agreed in the new pension agreement to raise the current (legal) retirement and state pension age to 66 in 2020. It will subsequently be determined every five years whether the pension age should be raised further due to rising life expectancy. The state pension will also be increased by an additional 0.6% annually during the period 2013-2028. This increase will come in addition to adjusting the state pension to the average increase in collective labour agreement wages. The starting age for state pension payments will also be flexible from 2020. The payment will increase by 6.5% for each year that the state pension starts later, while the payment will be 6.5% lower for state pensions taken early. Under the new system it will not be possible to receive a state pension before the age of 65.

The premiums for supplementary pensions will in principle remain stable for both employers and employees and will consequently no longer be an instrument for keeping the funding ratios of pension funds up to standard. Pension funds will also receive a longer period (up to ten years) to supplement deficits. This is countered by the fact that the amount of the supplementary pension is largely dependent upon the investment results. Pension funds no longer work with unconditional (nominal) rights. As a result they are allowed to discount their obligations using the expected portfolio returns rather than the risk-free interest. Pension fund

participants will as a result share much more explicitly in investment gains and losses.
The new pension agreement marks an improvement over the current pension system with respect to a number of points. For example, nominal pension guarantees have been abolished and pension funds will focus more specifically on achieving a real pension. It is a more honest approach because the current nominal guarantees are just as hard or soft as the underlying financial coverage. Risks in pensions, provided that they are well-distributed and not pushed to the future, are unavoidable. It is simply a fact that, without risk in the investment portfolio, the expected returns would just be too low to enable paying an indexed pension at affordable pension premiums. The new pension agreement also rightly states that higher pension premiums are not desirable. They not only damage the economy, but the premiums are also an increasingly less suitable instrument for absorbing setbacks at pension funds because the number of people working is decreasing relative to the number of retirees.

Who loses out?

The above mentioned plus-points do not, however, outweigh the shortcomings of the new agreement. A key objection is that the risks in the new agreement have been placed to a greater extent with younger generations. The agreement also does not provide any solutions for the virtually non-functioning labour market for older employees. What's more, the target of structurally improving the sustainability of government finances by only 0.7% of GDP (€ 4 billion) is rather disappointing (CPB, 2011).

Baby boomers spared

The fact that the state pension age will not be raised until 2020 means a large proportion of baby boomers born between 1945 and 1955 will be completely unaffected. Only people born in or after 1955 will have to work until the age of 66. The baby boomers will also benefit from the additional 0.6% increase in the state pension from 2013 on top of the indexation with the average increase in collective labour wages. As a result, retiring at 65 in 2020 will entail almost no adverse financial consequences. An illustration: a single person born in 1955 would under the current system receive a state pension of € 1,221 a month in 2020.[4] Under the new system the monthly state payment would be reduced to € 1,196 in the case of early retirement.

Non-functioning labour market for older employees

The new agreement lacks agreements on the non-functioning labour market for older employees.[5] Raising the effective retirement age to the current level of 65 already requires a major effort. And without further labour market reforms, raising the state pension age to 67 would magnify the existing problem. Structural reforms such as shortening the duration of unemployment benefits, simplifying dismissal procedures and relaxing dismissal criteria are needed in order to revive mobility among older people in the labour market. The pay system, which is predominantly based on seniority, must be revamped so that older employees' wages are more in line with their productivity.

Discount rate: a new magic potion

Nominal pensions are paid unconditionally according to the current pension contract. Pension funds must consequently value their future obligations at the risk-free interest rate. The new pension contract allows obligations to be valued at a discount rate that reflects the expected average long-term returns and related risks. The reasoning is that the pension rights will move in tandem with the achieved investment results in future, which justifies a

[4] Based on a 1.5% annual increase in state pensions in line with the average state pension increase over the past two years.
[5] The proposal for a mobility bonus for employers who hire an older employee is not a step in the right direction. This measure suggests that employers must be compensated for hiring less productive older employees.

risk mark-up on top of the risk-free interest rate.

Under the new system, pension funds will consequently receive more scope for independently determining the discount rate they consider reasonable. This creates the risk that they will incorrectly overestimate their wealth by employing a discount rate that is too optimistic compared to the long-term returns they can reasonably achieve. This will endanger younger people's pension rights. Kocken (2011) has calculated that young people would see 16-30% of their current nominal pension value evaporate upon entering the new pension system and that the realised returns are disappointing relative to the expected returns.[6] Even with better-than-expected returns, young people will still be worse off than in the current pension system. This is because the pension obligations in the new system are valued at a higher discount rate and the funding ratios consequently look much healthier, resulting in older people receiving more indexation. But in the end, there will be less left in the reserves to make payments to young people.

Younger working generation bears more risk

The new agreement's greatest flaw is that it lets pension funds too readily commence with indexation while there is actually not enough money in the pension reserves. In contrast to the current system, which only allowed indexation providing there was a funding ratio of 130% or higher, the new system does not require an additional buffer in order to be able to index. As a result more pension capital will be allocated to older generations than is prudent, while the risks will be shifted to younger generations.[7] So this essentially entails dipping into the pension reserves without providing young people with sufficient clarity as to what their future pension contract will look like (Jacobs, 2011).

En route to a future-proof system

The new pension agreement encompasses a number of fundamental shortcomings. In order to spread the bill for the ageing population more effectively across the generations, a combination of a phased increase of the pension age to 67 in 2020 and subsequently linking the pension age to life expectancy is a more effective approach. As a favour to older employees, the social partners should ensure that raising the pension age is accompanied by measures that can help revive the labour market for older employees rather than handing out 0.6% annual bonuses. Clarity must also be provided as to the distribution of the risks between younger and older people. Disappointing investment results should immediately be translated into lower pension payments and rights. The lower buffer requirements must not be used as an excuse for an immediate return to wide-scale indexing. In closing, clear guidelines for using the discount rate are needed. They must above all be prudent in order to ensure they do not undermine the sustainability of the Dutch pension system.

Conclusion

The ageing population and the deteriorated financial position of pension funds necessitate a new pension agreement. But the new agreement is a weak compromise that places risks primarily with younger generations. The higher pension age date will be introduced too late under the new agreement. This will keep older generations out of reach, while letting pension funds overestimate their wealth and pass the bill to future generations.

[6] The calculation is based on a discount rate of 6%. This is based on the average expected returns over a 20-year period, consisting of 4% risk-free interest plus a 2% risk premium. The realised returns vary from 0% to 4%.

[7] The real funding ratio of pension funds forms a good gauge for determining whether indexation is appropriate. If this amounts to at least 100%, the funds will have sufficient funds in the reserves to meet and moreover to compensate inflation. There are, however, in practice few funds that have a funding ratio at or above 100%.

July 2011
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