COUNTRY SPOTLIGHT NETHERLANDS

# Blades of change

**Newly-agreed changes to the Dutch pension system represent a great leap for one of the planet's forerunners.** Duncan Ferris **examines how the reforms might affect savers on the street, pension professionals and investment tactics**

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When Michael Jordan said: "I believe greatness is an evolutionary process that changes and evolves era to era," it's unlikely that he was speaking about the Dutch pension system. It is a quote that seems oddly pertinent when examining the upcoming changes to how the nation's workers will be saving for and enjoying their retirement though.

In 2019, the Dutch pension system was crowned as the world's finest by the *Melbourne Mercer Global Pension Index*, narrowly beating out Denmark to hold the top spot for the second year in a row. If you like, the Dutch seem like the Michael Jordan to Denmark's Magic Johnson. But just as Jordan spoke of the need to keep things moving, the seemingly exemplary Dutch pension system is set for a shakeup.

In essence, the transformation will see it move from a defined benefit (DB) style structure to defined contribution (DC). The government, employers and trade unions reached an agreement in July for the new measures to gradually come into force by 2026/27.

### A fair deal?

With such sweeping reforms being introduced, it makes sense to first examine whether they are fair to the people to whom they will matter the most – retirement savers.

APG managing director for strategic portfolio advice, Onno Steenbeek, is positive about the effect that the changes will have for savers, arguing that the new system "better reflects the risks in the system and it will enhance the personalisation of pensions".

He adds: "Tailoring pensions to individual preferences will improve by, for example, the provision of a partial lump sum, more detailed tailoring to risk appetite and retirement date flexibility (in case of physically demanding jobs).

"Choice architecture will develop to enable participants to shape their pension to their personal needs. The new pension contract also unlocks value in existing pension savings by introducing annuities that move along with investment returns."

Aon senior ALM consultant, Corine Reedijk, examines how the removal of so-called buffers from the system will affect savings, noting that this means that "all available means can be given to the participants", which will increase pension incomes but create a "bigger risk of reductions" because of fewer safety nets.

Reedijk adds that investment returns can be attributed differently to different age groups, sharing the example that "young people can invest 100 per cent" in equities, which she states "will lead to welfare gains for the total population, according to the calculations of the Dutch Central Planning Bureau (CPB)".

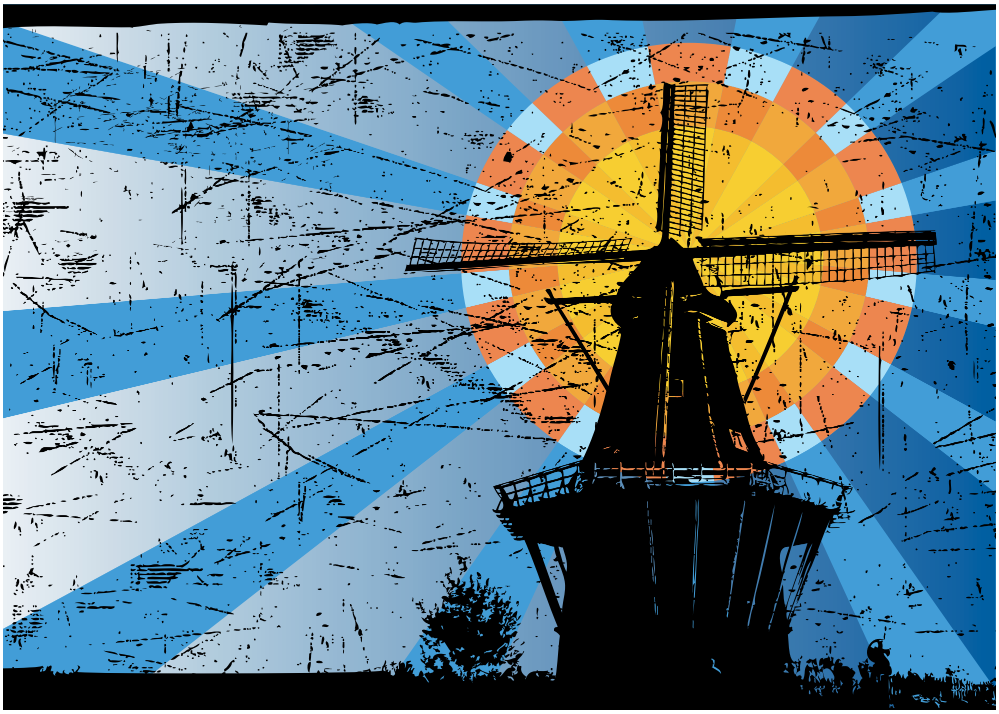
Reedijk concludes on the matter: "From calculations of the CPB, it shows that all participants benefit from moving to the new system. The participants receiving their pension benefit from the fact that in the new system no buffers are built up and investment windfalls are directly translated in indexation. The drawback is that in the case of setbacks, benefits are reduced. Participants will receive a more volatile pension."

Speaking in June, AXA Investment Managers head of quant lab, Laurent Clavel, raised a similar issue as he made one major downside of the new system clear. He commented: "You have to be mindful that the risk is not gone. You have transferred the risk from the state, eventually, and the regulation, to the people, to the pensioners, because you are no longer guaranteeing anything."

This makes it seem like something of a slam dunk for savers, but once we arrive at the issue of how the changes will affect those already receiving their pension, we begin to learn about the challenges that administrators could face.

### Admin challenges

For those already receiving benefits, Reedijk points out "if participants already receive a pension from an insurer" it is not



> "BY DEFAULT, THE ACCRUED RIGHTS ARE MOVED TO THE NEW SYSTEM"

expected that their benefits will be affected by the changes.

She further explains: "By default the accrued rights are moved to the new system. However, it is possible to leave them behind if the calculations show that leaving them behind benefits the participants. In that case, two different pension contracts have to be administered; one for the old accrued rights and one for the new rights."

While this is fairer for individuals already receiving a pension, this of course represents a difficulty for administrators and pension fund boards, who will either be responsible for the fair transition to the new contract or be left spinning two plates at once.

But it is not the sole challenge that pension professionals will be confronted by during the transition to the new system.

Reedijk outlines several further key challenges for administrators, beginning with the fact that, under the new contract, investment returns are attributed differently to different age groups. Administrators will also be expected to organise hedge returns and a solidarity reserve, which Reedijk explains is meant to be "fed with excess returns and premiums and is used in times of bad investment returns".

Steenbeek concurs that administrators face "substantial adjustment" due to the reforms but points out a different concern for administrators, stating that "the most important challenge concerns the communication to participants and pensioners".

He comments: "For them it is important to understand the value of their pension and pension savings and the choices they have to tailor it to their personal needs. Also, the administrative systems will be further enhanced in order to communicate via personal pensions accounts, possibly incorporating other sources of pension income such as first pillar benefits."

Despite the difficulties caused by this process, Steenbeek remains confident that, following the adjustments required to adapt, the administration systems "should be simpler than they are today".

**Investment**

Research from the European Commission published in April 2019 found that bonds were the most common investment, with debt and fixed-income securities accounting for 48 per cent of total investment. Meanwhile, equities and other variable-yield securities made up 37 per cent, real estate was 9 per cent of the total, and other investments made up 5 per cent.

However, this makeup could change with the leap to a new system, as institutional investors look to achieve new targets for their funds in a DC environment, meaning that administrators will not be the only pension professionals with a tricky task on their hands.

Reedijk first notes that, although it will be standard practice for the assets to be transferred to the new system, they can be left behind in the old one "based on substantiated arguments and calculations".

Then, on the topic of how investment practices might change under the new system, she notes that the first step for funds is "the determination of the risk attitude of the population".

Reedijk comments: "It could be that the risk appetite is somewhat more offensive as the new system has more volatile pension payments. Then the total asset portfolio can be invested somewhat riskier. Furthermore, the hedging of the interest rate risk will be set up differently.

"Currently, the liabilities are determined based on the risk-free interest rate term structure and this is the basis for hedging collectively. In the new system the hedging return is based on (probably) individual cashflows.”

Speaking in June, AXA Investment Managers country manager in the Netherlands, Hanneke Veringa, stated that asset allocations were expected to change “massively” over the period of transition to the new system, predicting that the changes would lead to €500 billion-worth of assets being transferred from liability driven investments to cashflow driven investments.

She added: “That will imply that pension funds are expected to move out of govies, potentially out of long-dated swaps with a maturity of over 10 years and increase their allocations to credits in particular, and potentially also index linked bonds.”

Steenbeek agrees, stating that the move will mean that the focus of investment policy will likely shift “from benefits and coverage ratios towards capital accumulation and return”.

He continues: “Depending on the details of the contract (either the more individual or the collective variant), asset management and the corresponding risk management may be affected. In case of the collective variant, the strength of long-term responsible investing in broadly diversified portfolios will be strengthened.

“Corresponding risk management may be affected by changing attitudes towards interest rate hedging and resulting liquidity requirements. In case of the individual variant, diversification may be limited to mostly liquid asset classes.”

**“WE THINK COMMUNICATION IS KEY IN BOTH THE TRANSFER TO AND IMPLEMENTATION OF THE NEW SYSTEM”**

Steenbeek adds that none of this is certain as “many important details of the new pension contract are still not decided upon”, explaining that the mixture of assets invested in “may become more or less risky” depending on the final deal.

## Risks

As well as some challenges for pension professionals, there are of course always some risks associated with any sweeping systematic changes. While this piece has already covered the issue of the element of risk being passed on to individual savers, what wider issues are there?

Reedijk explains: “Currently, most pension funds in the Netherlands are not in good shape and have reserve deficits. For this year the minister changed the rules for benefit cuts. Normally, a pension fund would have to cut benefits if the funding ration is below 104.3 per cent five years in a row. Now this has been changed to 90 per cent.

“It is still unclear what the rules will be in the period till 2026. The risk of significant benefit cuts in the transition period is one of the big risks at this moment. That risk affects the support for the new system and more specifically the time needed to move to the new system. Pension funds would rather move quicker.”

Reedijk adds that another risk of the reforms is the member communication associated with it, noting that the introduction of more transparency and solidarity mechanisms such as different investment returns for different age groups “will require good communication”.

She adds: “The move from the old to the new system and how current entitlements are transferred to individual savings requires good communication as well. We think communication is key in both the transfer to and the actual implementation of the new system.”

“Furthermore, starting points for the transition from the old to the new system are cost neutrality on one hand, and compensation of participants who have a deterioration of pension outcome on the other hand. These starting points will be difficult to combine.”

Steenbeek is more positive, commenting: “The transition to a new pension contract mitigates risks by personalising pensions to fit ever-changing labour markets and offer income security to pensioners as well. In this transition, pension funds and their pension delivery organisations are challenged to use their ability to be in control to manage change.” ■