



## PENSION REFORM IN THE NETHERLANDS – THE MOVE TO DEFINED AMBITION PENSIONS

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In 2011, the Melbourne Mercer Global Pension Index once again ranked the Dutch pension system first.<sup>1</sup> Nevertheless, the Dutch pension system is unsustainable in its present form and is set to undergo a fundamental change. At present, the pension system in the Netherlands is primarily defined benefit – in 2010, almost 78% of Dutch pension plans were defined benefit<sup>2</sup> – and the system has become unaffordable. In this article, we describe the current state of pensions in the Netherlands and take a look at the recent pension agreement, ongoing issues and proposed legislation. Will the Netherlands move from defined benefit to defined ambition pensions?

### Pension agreement

In June 2010, as a result of the financial and economic crises, low interest rates, an ageing population and increasing life expectancy, the Dutch social partners signed a new pension agreement (*Pensioen Akkoord*). The parties agreed to increase the retirement age for both occupational and state pensions from 65 to 66 in 2020 to be reassessed every five years to see if further increases are required. The state pension will be guaranteed to rise in line with wage inflation until 2028 and will also increase by 0.6% annually from 2013. In addition, the state pension age will be made more flexible, with pension benefits being reduced for early retirees and increased for later retirees. Another change that will have a considerable impact on the present system is that pension contributions (which are mostly paid by employers) will be capped at present levels and will not rise any further. The current level of contributions is almost 13% of total wages and the Netherlands Bureau for Economic Policy Analysis (*CPB*) has said that this would need to increase to more than 17% of gross salary by 2025 in order to maintain present benefit levels.<sup>3</sup>

In order to keep workers in employment for longer, employers will also receive a 'mobility bonus' for employing elderly workers. In addition, contribution holidays will not be allowed in economically prosperous times but nor will contributions have to be immediately increased in difficult times. By doing this, the government hopes to ensure that, in hard times, economic recovery will not be hampered by companies being forced to pay for additional pension liabilities.

<sup>1</sup> *The Melbourne Mercer Global Pension Index* compares pension systems around the world. For the latest survey, published in October 2011, see <http://www.globalpensionindex.com>.

<sup>2</sup> *Verzekerd van Cijfers 2011 (Dutch Insurance industry in figures)*, Verbond van Verzekeraars, 2011.

<sup>3</sup> *Een sterke tweede pijler*, report Goudswaard (on long-term sustainability of pension schemes in the Netherlands), 2010. Comparing these figures to for the UK, aggregate contributions into DC plans are significantly lower than those into DB plans. Average aggregate contributions into open DB plans in the UK were 20.3% of salary in 2009, but 9.4% into open DC plans.

## The move to defined ambition

If pension contributions are fixed at today's levels, the problem of rising life expectancy or lower than expected investment returns must be resolved in another way. The solution agreed upon is shifting this risk to employees. This means that the risks of longevity, interest and return on investments will be borne by employees. In the words of the agreement itself, 'the social partners set out the basic principles for a new, more transparent pension contract that takes into account developments in life expectancy and the financial markets.' It seems that the present Dutch nominal defined benefit pension system will change into a form of defined contribution (DC) system (a collective DC or CDC) pension scheme, which some are now calling a defined ambition (DA) pension scheme.

For many years, the Dutch defined benefit pension system has seemed rock solid. That feeling is now gone. Pension funds can no longer guarantee the pension rights of their participants. The coverage ratios of many Dutch pension funds (including the five largest pension funds) have fallen below the minimum funding requirement, making indexation impossible and increasing the likelihood of benefit cuts. The pension system that seemed so secure is not as solid as it once appeared.

## Opposition remains

Last summer, the protests started, led in particular by the *FNV*, an umbrella organisation of Dutch trade unions. Although the *FNV* was one of the social partners that signed the pension agreement, the unions started to revolt. In order to save the pension agreement, the Social Affairs' minister, Henk Kamp, made a number of concessions. He met one of the remaining objections of the *FNV*, after promising that employees could continue saving for early retirement through the tax-friendly life-course – or *levensloop* – scheme. He also agreed with the *FNV* that workers will be able to save as much as €20,000 in a new tax-friendly 'vitality scheme' (see box below). In addition, low-income workers who keep working after 62 will get €9,000 rather than €5,000 in tax benefits, so they can still retire at 65 as of 2020, when the official retirement age will be raised to 66.

The *FNV* finally endorsed the pension agreement in September 2011. However, the two largest members of the federation – the market sector union *Bondgenoten* and the civil service union *AbvaKabo* – still did not agree and have said that they 'do not feel bound' by the deal. These two unions have already announced that they will demand compensation (for instance a rise in pension contributions by the employer) during the next negotiations with the employer organisations for collective labour agreements.

## Proposal of law

On 17 October 2011, the Dutch government published a proposal of law which translates the pension agreement into legislation. For state pensions (the Dutch *AOW*), the retirement age will increase from the current 65 to 66 in 2020, and probably to 67 in 2025. Future possible increases will reflect life expectancy. By changing the tax law, second-pillar (occupational) pension arrangements will need to change the targeted retirement age to 66 starting 1 January 2013 and to 67 in 2015. Further changes in laws and regulations are expected in the spring of 2012, since the Ministry of Social Affairs is looking into some key aspects of the pension agreement.

## Remaining issues

Before March 2012, the government must have answers to a number of crucial questions related to the pension agreement. The most important ones are the following.

1. *Is it legally possible to make it mandatory to transfer accrued benefits into the new system?*  
Benefits that are currently considered unconditional would become conditional in the future. For the pension agreement to become a success, such a transfer is necessary. But according to many pension lawyers, a mandatory transfer is probably against European case law. The government is therefore looking for a solution for this.
2. *Generational transfers and conflicts of interest.*  
Dutch pensions are traditionally based on the idea of solidarity among generations. The pension agreement impacts perceived solidarity, with the younger generation strongly protesting what it considers a transfer of value to the older generation. During the parliamentary debate about the pension agreement in September, social affairs minister Kamp promised to 'legally secure a generation-proof pension contract that balances the benefits and burden between younger and older generations.'
3. *The discount rate.*

According to the pension agreement, pension funds will be allowed to estimate their investment returns for the purpose of determining the level of the funding ratio. Currently, all Dutch pension funds use the same discount rate to calculate the present value of the liabilities, but in the future every pension fund will have its own discount rate. This results in at least two issues. The first one is how the coverage ratios of the different pension funds will be compared in the future. This will be very difficult. The second one is more important and has led to considerable discussion in The Netherlands. If a pension fund were to choose a higher discount rate, it would have an improved coverage ratio, as its liabilities would fall. Many people fear that, as a result, schemes might pay out money that they do not have, thus leaving no money for younger generations. As a result of a discussion in Parliament, minister Kamp promised to take these fears into account.

### Impact on employers and employees

The forthcoming reform of the Dutch pension system will have a major impact on the pension landscape in The Netherlands. It is expected to give companies the opportunity to transfer their defined benefit pension risk (like longevity and asset returns) to their employees. As many Dutch companies still have defined benefit pension plans, this will allow companies to remove part or all of their pension risks from their balance sheets. Under the new agreement, employers and employees will be able to agree to one of two fundamentally different types of pension contracts: hard pension promises (guaranteed nominal pensions) or soft pension promises (flexible pension benefits depending on asset returns and longevity evolution).

The pension agreement is less clear for employers with insured pension plans. Insurance companies, by their nature, provide security by guaranteeing pension benefits, offering solutions for hard pension promises. However, if the system is to be altered, it should also be possible for insurers to offer products for soft pension promises. However, it is as yet unclear how insured solutions will fit into the proposed Dutch pension structure.

Second pillar or occupational pensions are the exclusive domain of the social partners in the Netherlands. By itself, raising the state retirement age does not automatically have any effect on the retirement age for occupational pension schemes. Similarly, reducing the maximum level of tax advantages for occupational pensions does not automatically lead to negotiations between employers and employees to adjust existing pension arrangements. However, when tax law is changed in such a way that individuals will only receive the same pension rights as currently

promised at the age of 65 if they work two years longer, it is inevitable that occupational pension plans will be altered accordingly.

### A new era of risk and responsibilities

In 2011, the Dutch social partners finally reached a pension agreement. Now it is up to the Dutch government to implement this agreement. This will result in a rise in the retirement age and a shift of risks (longevity, interest, and return on investments) to employees. The Netherlands has been a defined benefit country for many years, but it now looks like this is going to change. The Netherlands looks set to become a defined contribution country. As elsewhere in the world, employees will have to start taking more responsibility for their own old age income.

#### **Life-course, salary and vitality savings schemes**

*The Dutch government intended to end two tax-assisted savings schemes and replaced them with a single new scheme: the salary savings scheme and the life course savings scheme will be replaced in 2013 by the new vitality savings scheme. However, as a result of negotiations, under specific circumstances people with a life course savings scheme will be able to continue saving as before.*

##### **Life-course savings scheme (levensloop)**

*The Life course savings scheme will end as of 1 January 2012. If an employee has saved a minimum of €3,000 in a life course savings scheme account on 31 December 2011, they will be able to continue saving. If the employee has saved less than €3,000, they will be able to withdraw the balance in 2013. From 2012 onwards, they will no longer be able to make any deposits. All participants in the life course savings scheme will be able to transfer their balances untaxed to the vitality savings account in 2013. Up to 1 January 2012, the participant will be able to collect the accumulated rights to the Life course savings scheme's tax credit when the saved balance is withdrawn or when the Life course savings scheme is converted to a Vitality savings scheme.*

##### **Salary savings scheme (spaarloon)**

*The salary savings scheme will end as of 1 January 2012 and it will no longer be possible to make any deposits. Employees who now participate in the Salary savings scheme will be able to withdraw their entire accumulated savings from 1 January 2012 with no disadvantageous fiscal consequences.*

##### **Vitality savings scheme (vitaliteitsregeling)**

*A new salary savings scheme will be introduced as of 1 January 2013. This savings scheme, the Vitality savings scheme, will offer employees and self-employed people the possibility of saving with a tax advantage and of withdrawing the saved capital as the saver wishes. This savings scheme will serve as a supplement to income that can be freely withdrawn. The deposits will be tax-deductible and the government will only levy tax when the balance is withdrawn. No tax will be levied over the accumulated balance. Participants will be able to save a maximum of €20,000 with a tax advantage. There will be a maximum annual deposit of €5,000. Participants will be able to withdraw a maximum of €20,000 each year and then save again until the maximum is reached. From the year in which participants reach the age of 62 year on 1 January, they will be able to withdraw a maximum of €10,000 each year.*

*The vitality savings scheme will be fiscally attractive and will not be processed through the salary but through a tax return. This means the administrative burden on employers will be much lower. In both the life course and salary savings scheme, the employer has an administrative task. When an employee wants to participate in the vitality savings scheme, the employer will no longer play any role. If an employee participates in the salary savings scheme, the employer has to pay a 25% lump sum tax on the savings amount. The replacement of this savings scheme will therefore save the employer money.*