The AMBACHTSHEER Letter
Sustainable Pension Design • Effective Pension Management

February 2025

A DECADE OF PENSION REFORM IN THE NETHERLANDS:

WHAT ARE THE LESSONS ALL OF US CAN LEARN FROM THIS STORY?

"The Netherlands are moving towards a new pension system, which requires a great deal of effort from all parties involved: employers, employees, trade unions, work councils, pension providers, and asset managers."

NautaDutilh Law Firm, May 2024

"Following a process of over more than a decade, the largest-ever reform of the Dutch pension system, itself the largest occupational pension system in the European Union, is finally nearing a close. "

IPE Magazine, December 2024

"Agnes Joseph's proposed Entry Referendum to the new pension system is an example of sham democracy. How many plan participants will be able to make an informed choice? This amendment to the Future Pension Act is likely to be further amended and debated in Parliament in March."

Pensioen Pro, January 2025

*"**Path Dependence** refers to processes where past decisions constrain later decisions. It challenges new decisions that pay insufficient attention to earlier decisions."*

Wikipedia

Requiring a Great Deal of Effort

This *Letter* is not the place to detail all the complexities of the transition of the former Dutch occupational pension system to a new one. However, the three articles cited above provide a flavour of the decade-long Dutch reform effort, and indicate why this effort has been problematic. The goal of this *Letter* is to understand the lessons that can be learned from the Dutch experience, so that they can be put to good use in the design and execution of any future country effort to reform its retirement income system.

The *NauteDutilh* article condenses the Dutch pension reform process to five key elements:

1. DB schemes will disappear and pension funds can no longer make retirement income promises.
2. They will be replaced by three types of DC schemes.
3. The DB-to-DC transformaton is based on a transition plan, an implementation plan, and involves all (including former) employees.
4. Accrued pensions will be transferred to the new pension scheme.
5. Employers will have a duty of care.

The *IPE* article provides more details on the 'what' and the 'how' of the reforms:

- The new pension system will be DC rather than DB-based.
- There will be no individual right to object to the conversion calculation of accrued DB rights to a DC capital amount.
- The plan sponsors/social partners of the current 150 pension plans can chose between two types of DC plans: 'solidarity' or 'individual'.
- However, in both cases, investment risk is transferred from the collective fund level to the individual participant level.
- In the 'individual' version, plan members have personal pension pots and a choice of three risk profiles. However, longevity and disability risks remain shared.
- In the 'solidarity' version, additional collective features remain. For example, the asset pot is a single pool rather than individually allocated to plan members. Also, there is a collective 'solidarity buffer' to protect against pension cuts.
- Pension fund investment policies must be based on the risk preferences of plan members.
- Pension funds are required to conduct surveys to establish these risk preferences.
- This new requirement brings the Dutch finance/capital markets regulator AFM into the oversight picture to check on the quality of fund member surveys and communications.
- The shift to a DC-orientation should lead to more freedom to invest in risky assets and private markets.
- However, interest rate risk for older members/retirees should continue to be hedged.

The third quote on the front page from *Pensioen Pro* signals that a new spanner may have just been thrown into the wheels of the decade-long Dutch pension reform process. There is now a movement supported by some of the political parties to subject the transition to the new pension system to participant referendums at the individual plan level. Given the general lack of understanding and enthusiasm for the pension reforms by plan members, this new initiative could delay the reform process even longer.

All this brings to mind Marshall McLuhan's famous observation that "*the medium is the message*". In this case, the medium is a long, complex 'to do' list involving multiple tasks and multiple actors. The message is that complexity can overwhelm the best of intentions. Thus the Dutch pension reform effort is failing Albert Einstein's admonition "*to keep things as simple as possible…but no simpler*".

Simplifying Pension Design

Is pension design simplification actually possible? Our **April 2017 *Letter*** titled: "Integrating Pension Solidarity and Sustainability: Lessons from the Netherlands and Canada" addressed this question. The context at that time was the dysfunction of the solvency-based pension regulatory regime the Dutch pension regulator was enforcing In DB plans. The regulatory idea that DB plans should always have sufficient assets to pay all accrued pensions if it were to shut down was clearly problematical, causing low returns because of too little risk-taking, and ongoing ongoing retiree concerns of pension cuts. The *Letter* proposed two options for dropping the solvency-based pension regulatory regime in the Netherlands.

Option #1

*I wrote an invited paper in 2014 for the Royal Economics Society of the Netherlands (KVS) titled: "**Taking the Dutch Pension System to the Next Level: A View from the Outside**". A key argument in the paper was that pension plan design should reflect the logic of the Tinbergen Rule that the number of economic* *goals should be matched by the number of instruments designed to achieve them. Given the dual pension plan goals of affordability and payment predictability, the logic suggests Pillar 2 pension plans should have separate affordability and payment safety pools. The former focuses on long-term return generation to achieve the affordability goal; the latter on generating predictable pension payments for life to achieve the payment safety goal.*

The Life-Cycle Model of personal finance shows how these return-generation and payment safety pools are best employed. As affordability is the primary participant concern during the 'work' phase of the life-cycle, retirement savings should at first be fully allocated to the return-generation pool, with assets gradually shifting to the payment safety pool as the post-work phase of life comes into view. A 'default' transition path would help plan participants with this transition. Importantly, the return-generation pool would not be subject to any balance sheet restrictions, leaving its managers free to roam the world, seeking out the most attractive long-term return generation opportunities. Other design benefits include clear property rights, intergenerational fairness, longevity risk pooling, full transparency, and some important choice options for plan participants.

There is of course the practical challenge of how to unscramble the existing Dutch single-pool designs which place all plan participants (i.e., from young workers to aging retirees) on the same balance sheet with the same investment policy. Successful transition to the new pension requires three steps: 1. Design an equitable 'old-to-new' transition protocol, 2. Engage plan participants on the merits of moving to this model, and 3. Rewrite pension law and regulations to be consistent with the model. Writing this 2017 Letter almost three years after the original KVS paper, the Dutch debate on modernizing its Pillar 2 pension system continues, with a move to the two-pool model an option under consideration.

Option #2

Meanwhile, a growing number of Canadian Pillar 2 pension plans have transitioned from the traditional hard-core DB model to softer Target Benefit (TB) versions. These softer TB versions continue to maintain elements of collective risk-sharing, but have become more adaptive to changing circumstances through (a) taking a 'going-concern' rather than solvency view of funding, (b) establishing an explicit response protocol to changes in plan funded status over time (e.g., conditional inflation protection, adjustments in plan contribution rates) and (c) regularly measuring intergenerational plan fairness and communicating the findings to plan participants and sponsors.

In contrast to the Dutch situation, this transition has allowed many Canadian pension plans to: 1. Maintain a long-term investment focus, 2. Operate with lower asset coverage of accrued future pension payments, and 3. Maintain high levels of trust in plan sustainability. As a specific example, the Annual Report of the Colleges of Applied Arts and Technology (CAAT) Pension Plan of Ontario states that achieving the Plan's long-term investment return goals is tempered by explicit balance sheet risk controls and intergenerational fairness constraints. CAAT is not the only Canadian plan expressing confidence in the design and implementation of its balance sheet risk management framework. I could have picked any one of a dozen other examples.

Why the Dutch Should Choose Option 2

So, according to the 2017 *Letter*, the Dutch could choose one of two possible options to reforming their dysfunctional solvency-based 1-pot DB pension system:

- **Option 1**: move to the theoretically elegant 2-pot accumulation/decumulation model, with an age-based transition protocol that shifts individual member assets from the accumulation to the decumulation pot with the passage of time.
- **Option 2**: stay with the 1-pot model, but move to the Canadian Model 'going-concern' TB basis, with multiple levers to ensure that the plan remains both fair and understandable…. and hence sustainable.

In the end, we favored Option 2 as the best pension reform course for the Dutch. The 1-pot 'going-concern' TB model established a proven track-record in Canada by producing both sustainability and high levels of plan member trust and satisfaction. At the same time, staying with the 1-pot model would avoid the pitfalls of having to estimate the current market value of future pension payments, and allocate these assets between the accumulation and decumulation pots. Stated in terms of the front-page definition of **path dependency**, choosing Option 2 eliminates the difficult requirement to undo and reverse decisions made many years ago.

The Dutch Choose Option 1++

So what was the pension reform option actually decided in the Netherlands? Definitely not Option 2…..but not necessarily the simple version of Option 1 either. Going back to the *IPE* article referenced early in this *Letter*, consider the following complexities and contradictions:

- How to establish the risk preferences of individual plan members who have never been asked this before?
- Which of three possible risk profiles is the best fit for each member?
- How will the 'solidarity buffer' work?
- How will longevity and disability risks be shared?
- What will be the respective regulatory roles of the DNB and the AFM?
- How will interest rate risk be hedged for older plan members?
- Why will all this necessarily lead to riskier/higher return pension fund investment policies?

So not only were the path dependency problems ignored by choosing Option 1, the transition was further complicated by adding multiple bells and whistles to the basic version of Option 1 (e.g., multiple member risk profiles, solidarity buffers, complicated regulatory oversight, etc.). So in the end, the choice was not Option 1, but Option 1++. Further, it now looks as though participants may get the opportunity to reject transitioning to Option 1++.

Four Lessons Learned

So what can other countries learn from this decade-long pension reform story in the Netherlands? It suggests the best results will come out of a well-managed 4-step process:

1. Based on first principles, lay out the pension plan design that best combines worker/employer affordability and payment safety needs in an understandable fashion.
2. Identify any path dependency-related barriers standing in the way of moving from the current pension plan design to the new ideal plan design.
3. Resolve how these barriers are best addressed, mindful of Einstein's rule to 'keep things as simple as possible, but no simpler'.
4. Communicate the resulting transition plan widely in understandable terms to achieve participant buy-in before the transition process starts.

Simply stated….but challenging to implement.

Keith Ambachtsheer

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