Intergenerational risk sharing in Dutch pension plans

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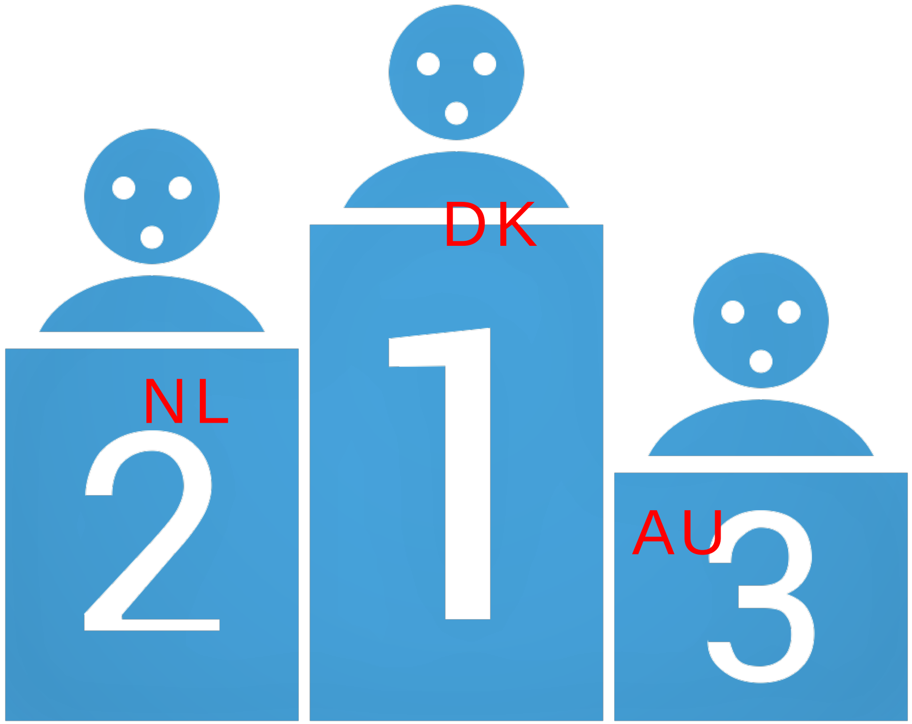
Understanding Society

The Dutch 3-pillar pension scheme

Mercer Global Pension Index 2017



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The Dutch 3-pillar pension scheme

- Good points (according to Mercer):
  - Generosity of Dutch pensions
  - Coverage

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The second pillar (collective supplementary pensions)

- Points to improve (the Dutch debate):
  - Communication policies of pension funds
  - Little flexibility
  - Wage-earners and self-employed persons
  - Intergenerational risk sharing and redistribution

Intergenerational risk sharing

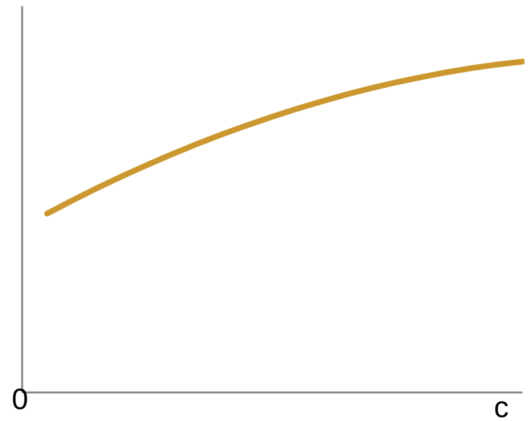
- Collective pension schemes share risks:
  - Equity return risk
  - Interest rate risk
  - Inflation risk
  - Longevity risk
  - Labour productivity risk

Intergenerational risk sharing

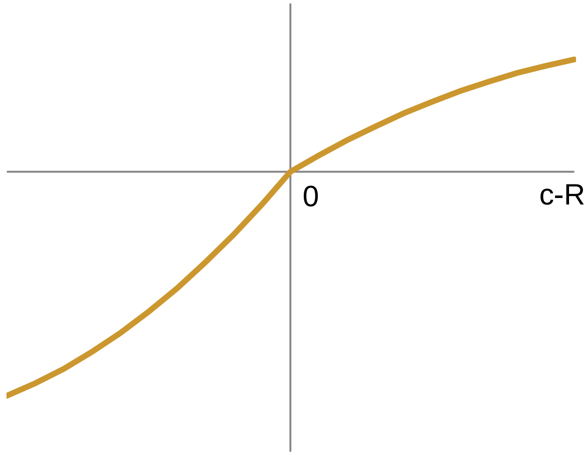
- Risk sharing is welfare-increasing
  - Expected utility:
    - Coefficient of risk aversion
  - Prospect theory:
    - Degree of loss aversion

Intergenerational risk sharing

- Expected utility



- Prospect theory



Intergenerational risk sharing

- *Ex ante*, risk sharing is welfare-increasing
  - For all participating generations
- *Ex post*, it may be perceived as welfare-reducing
  - Again for all generations

Intergenerational risk sharing

- Is risk sharing really welfare-increasing?
  - Equity premium
  - Inflation risk premium
  - Country risk premium

Intergenerational risk sharing

- How do pension funds implement risk sharing?
  - Pension contributions
    - Employers
    - Workers
  - Cuts in the indexation of pensions
    - Pension benefits (retired)
    - Pension accruals (workers)
  - Funding ratio

Intergenerational risk sharing

- Before 2000
  - Pension contribution rate
    - 1/3 employee
    - 2/3 employer
  - Lumpsum payments by employers

Collective pension funds in the Netherlands

	1998	2007	2016
DB, final wage	66.5	3.2	0.2
DB, average wage	25.0	87.8	90.3
DC	0.5	4.7	7.0

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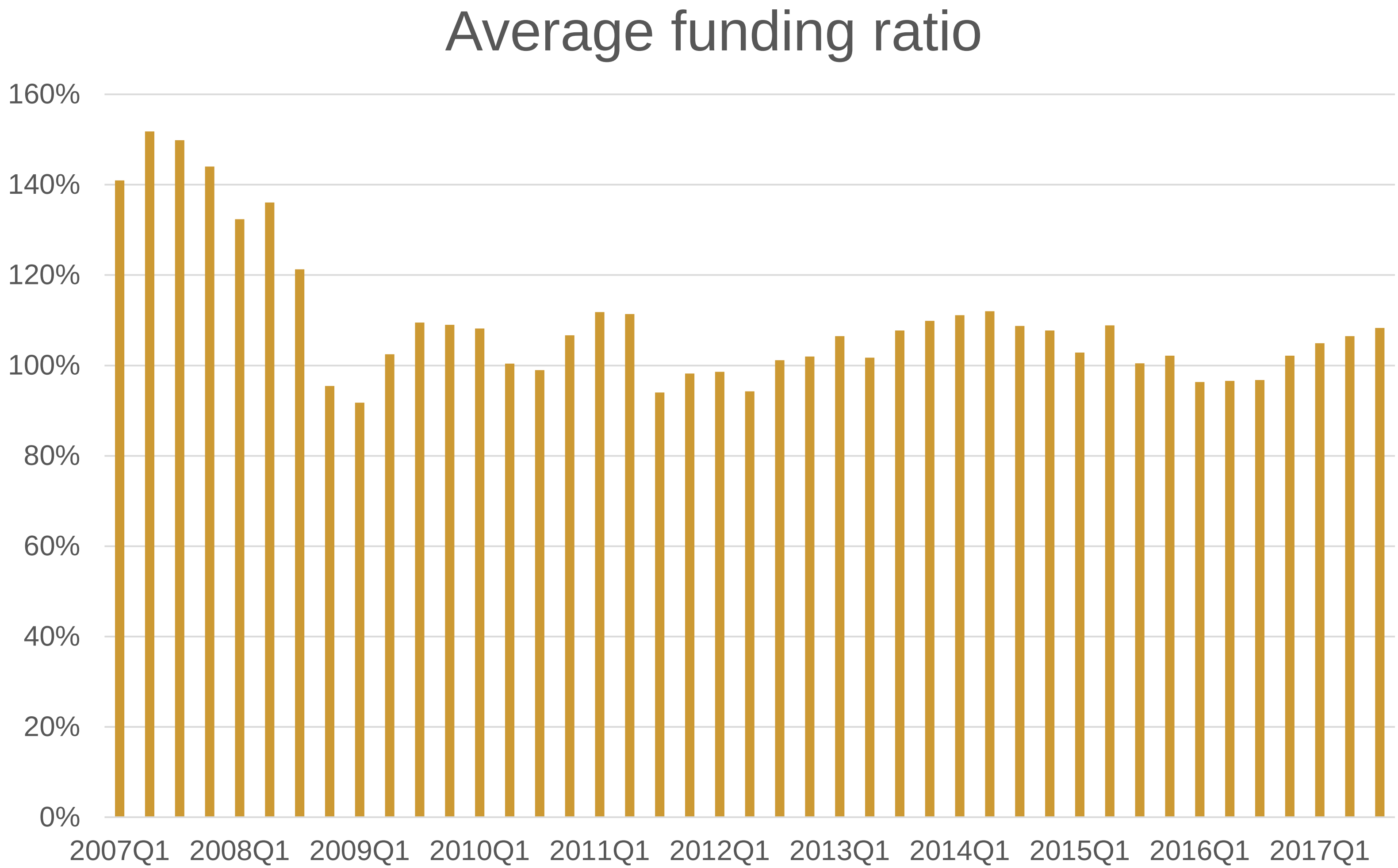
Intergenerational risk sharing

- After 2000
  - Indexation cuts
  - Cuts in nominal pensions
- According to expected utility theory
  - The two are equivalent
- According to prospect theory
  - The two may be very different

Intergenerational risk sharing

- Smaller role for pension contributions
  - Intergenerational risk sharing ↓
- Bigger role for indexation cuts
  - Intergenerational risk sharing -
- Bigger role for funding ratio
  - Intergenerational risk sharing ↑

Collective pension funds in the Netherlands



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Funding ratio

- “Balance” between
  - Shocks in life expectancy and interest rate
  - Indexation cuts

Loss of purchasing power

- 2007-2017, the Netherlands:
  - 5-6 percent loss due to indexation cuts
  - 2 percent loss due to nominal cuts
  - Total: 7-8 percent loss
- 2011-2017, ABP, the largest pension fund in the NLs:
  - 13 percent loss

Loss of purchasing power

- *Ex post*, intergenerational risk sharing may be perceived as welfare-reducing
  - By all generations
- Series of cuts in indexation and nominal pensions have led to an intergenerational conflict
  - The old: back to guaranteed pensions
  - The young: get rid of any guarantees

Coalition agreement

- Abolish uniformity pricing
- Move towards a system of individual pensions with a collective buffer
- Investigate the option of lumpsum take-ups at retirement

Abolish uniformity pricing

- Less redistribution between young and old workers
- Less distortion of the decision to become a wage earner or self-employed
- But: transition problem
  - How to compensate all working generations for their excess contributions?

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A system of individual pensions with a collective buffer

- Every participant has his or her own account
  - Greater transparency
- Via the buffer, intergenerational risk sharing will be preserved
- Details unknown yet:
    - Buffer cannot be negative
    - Size buffer is limited
  - Intergenerational risk sharing ↓

Lumpsum take-ups at retirement

- Investigate option to take up part of accrued pension wealth upon retirement
- The Netherlands are unique, together with Norway
- Greater amount of flexibility
- Take care of unwarranted take-ups
  - Limits to lumpsum amounts
  - Financial choice architecture

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