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Network for Studies on Pensions, Aging and Retirement

The Dutch Pension Reform

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The current Dutch retirement system

- First pillar
  - about 1.000,-/month; non-means tested
  - pay-as-you-go
- Second pillar
  - average also about 1.000,-/month (but heterogeneity)
  - fully funded 1.5tn = 2xGDP; premiums up to 25% of salary
  - most is (former) DB with “income entitlements”, liability valuation, and funding ratio-based adjustments:
    - funding ratio > 115%: entitlements/pensions increased
    - funding ratio < 90%: entitlements/pensions reduced
- Small third pillar

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Why do we (think we) have a problem?

- The best/second-best system in the world…
  - low poverty among elderly
  - high funding ratios (>105%) with default-free/swap discount rate
- (Perceived) problems
  - over-promised inflation-linked pension payments, while regulations implied no (nominal) increases over 2010-2021
  - some pensions have been reduced by 25% in real terms
  - discussions on regulation (discount rate)
    - “elderly were promised this/that, and promise must be kept”
    - “not fair to shift the bill to younger generations”

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A new CDC scheme

- We keep
  - mandatory enrollment
  - limited individual choices
  - life-long pensions/longevity risk-sharing
- We change
  - no more DB-style “income entitlements”, but individually administered accounts
  - explicit risk-sharing rules, with market-consistent valuation

The technicalities

- Why is a pension fund different from a mutual fund?
  - mutual fund: all shocks equal effect on wealth
  - pension fund: all shocks equal effect on (projected) income
- Borch-type risk-sharing, Pareto efficient with respect to <u>income</u> (not with respect to wealth)
- Individual wealth receives annualy
  - hedge return to maintain income level (term structure based)
  - equal share of fund excess return (life-cycle/human capital based)

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Observations on the new scheme

- We will have
  - classical DC with individual life cycles
  - previously mentioned new DC based on risk sharing

- Political outcome: virtually identical schemes…
  - bit more individual choice in the “classical DC” scheme

- This will work

Mandatory conversion of existing rights

- Unlike *any other reform* I know, we will transfer old DB entitlements to new system

- This leads to (lots of) valuation discussion
  - Which discount rate?
  - How to allocate over/underfunding?
  - Valuation of “embedded options”

Observations on the conversion

- Political “solution”: frame as a technical/scientific problem
  - including value-based ALM/risk-neutral valuation techniques…
- (My) answer: redistribution is inherently a political question
- We expect lot’s a courses cases…
- Solution: do as the rest of the world, no *mandatory* conversion of old entitlements

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