

Focal Point

The Dutch pension fund industry reform proposal

April 9, 2020

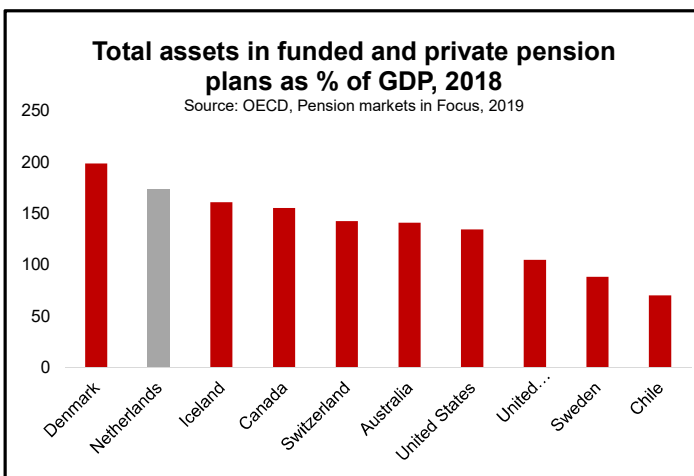
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The Dutch pension fund industry is facing yet another reform. The main innovations, which go towards a more market-consistent direction, are:

- **Change of the risk-free rate term structure**, to be introduced on January 1, 2021, towards a **more market-based Ultimate Forward Rate (UFR)**.
- **Reduction in assumptions on returns for various asset classes**
- **Pension contract re-design**, characterized by an **Accrual phase** at the individual level, **based on Lifecycle** strategies, and a collective **Retirement phase**, with investment and longevity risks shared among all the universe of pension funds' participants.

Although the overall proposal should take at least 3 years to be operative and a number of non-negligible details are still to be defined, we expect that the reform will **reduce by 2.5% on average the funding ratio**, which is already **under pressure** due to the low yield environment. This should call for **an increase in pension contributions rate in order to avoid pension cuts**. **LDI strategies and ALM-consistent allocations should become key in the years to come.**

The Dutch newspaper Telegraaf reported, at the end of February 2020, of a reform proposal for pension fund industry in the Netherlands (1.45 trillion euros AUM in 2018, the second in OECD countries and in Europe by Asset size over GDP) that has been agreed on by all parties involved (public and private). Although the overall reform should take at least 3 years to be operative and a number of non-negligible details are still to be approved by the Dutch Parliament, it is possible to shed some light on the main impacts the proposed innovations should come along with.



The main innovations proposed

1) Change of the risk-free rate term structure for Dutch pension funds: Liabilities of pension funds and life insurers typically have very long times to maturity. The choice of the risk-free rate is key because, through the valuation of the liabilities, it influences the financial position of the pension fund or the life insurer and therefore the allocation of wealth and risk across the different stakeholders.

Dutch pension funds have used UFR-adjusted curves since 2012 and important reforms to the methodology were introduced in 2015 (see Langejan et al., 2013).

The "Commissie Parameters" (Dijsselbloem et al., 2019) has proposed to **change the current UFR method**, leading to a **more market-consistent valuation curve**. Key aspects of the proposal are:

- an adoption of market rates until a **maturity of 30 years** (instead of 20 years) and
- a **slower convergence** to a (currently) lower UFR for long maturities.

The Dutch Central Bank (DNB) and the Dutch Cabinet have already endorsed this new approach, which is intended to be introduced on January 1, 2021.

2) Reduction in assumptions on returns for various asset classes: The Committee had also recommended a reduction of the permissible assumption for return on **listed equity by 1.2 percentage points to 5.8%**. It

decreased the parameter for other securities, including **private equity, to 7.5%**. For non-listed equity and commodities, the committee proposed to limit return assumptions to 4.8% and 3.5%, respectively. It further advised to factor in a **1.9% inflation** drawn on the consumer index as well as a **salary inflation of 2.3%**.

3) Pension contract design: only one new pension contract remains. The pension contract will split up all pension funds into a:

- **Accrual phase** – Every participant has his own personal pension account and investments will be **based on the Lifecycle principle**: This means the **riskiness of the portfolio decreases with age**.
- **Retirement phase** – This is a fund with **the assets of all retirees and upcoming retirees combined**. The fund participants will share risks like the investment and longevity risks similar to the current set up of pension funds.

4) An increase of participants' say in their pension fund's responsible investment policy: The initiative legislation is to provide a **right of advice for responsible investment** as well as a right of approval for exclusion from investment. Parliament is still to debate this initiative.

The likely consequences of the reform

Changing the risk-free rate term structure and the assumption on asset classes returns could imply:

- **A reduction of the funding ratio and the mounting threat of pension cuts**: The proposed UFR ratio, being more close to market values (lower yields), implies higher current values of future liabilities and, therefore, a decrease in **funding ratios**¹. Dutch pension funds are already struggling with deteriorating funding ratios due to low yield environment: Dutch funds regulation imposes a recovery plan to restore solvency when the funding ratio falls below 105%. If the coverage ratio falls below 90%, pension funds are required to implement benefit cuts. Given the effects of low yields, in June 2019 the first thresholds has been temporarily lowered from 105% to 100% (thereby introducing more flexibility and giving pension funds more time to restore solvency). However, some major pension funds are now falling below 90% cover ratio: the pension fund for people working in the government and education sector (Stichting Pensioenfonds ABP) reported, in fact, a drop to 88.7% over February, so the threat of actual pension cuts is rising.

The adoption of the proposed UFR would, all other things equal, worsen the situation: according to Wouter Koolmees, the minister for social affairs, the new UFR would cause pension funds' coverage ratio to fall **by 2.5 percentage points on average**. According to Aegon Asset Management, on average the impact on the funding ratio could reach 3.7%. **LDI strategies and ALM consistent allocations should become key in the years to come**.

¹ A **ratio** of a pension or annuity's assets to its liabilities. A **funding ratio** above 1 indicates that the pension or annuity is able to cover all payments it is obligated to make

- **A reduction in the demand of interest rate risk hedging**: Currently, many pension funds hedge the interest rate risk on bond holdings. The shift of the Last liquidity point (from 20 to 30 years) **affects the interest rate sensitivity**, making it more close to the one that would result by using the market curve. This would on the one hand, increase the interest rate sensitivity of liabilities (for maturities above 30 years). On the other hand, it would reduce the need of hedging the interest rate risk: the hedge ratio, in fact, measures the sensitivity of the plan's assets to a change in interest rates as a proportion of the sensitivity of the plan's liabilities to the same change. The proposed UFR, being much closer to the market interest rate, would lead to a reduction of the hedge ratio, via an increase of the denominator (interest rate sensitivity of liabilities). In the table below, the impacts on an average Dutch pension fund computed by Aegon Asset Management are shown.

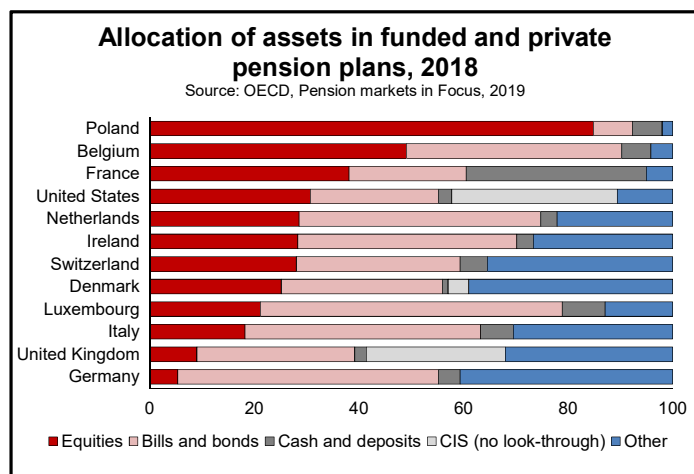
Impact on an average Dutch pension fund			
	Market curve	Current UFR method	Proposed UFR method
Value liabilities	100.0%	96.0%	99.6%
Interest rate sensitivity liabilities	100.0%	80.0%	97.6%
Funding ratio	100.0%	104.1%	100.4%
Interest rate hedge ratio	50.0%	62.5%	51.3%

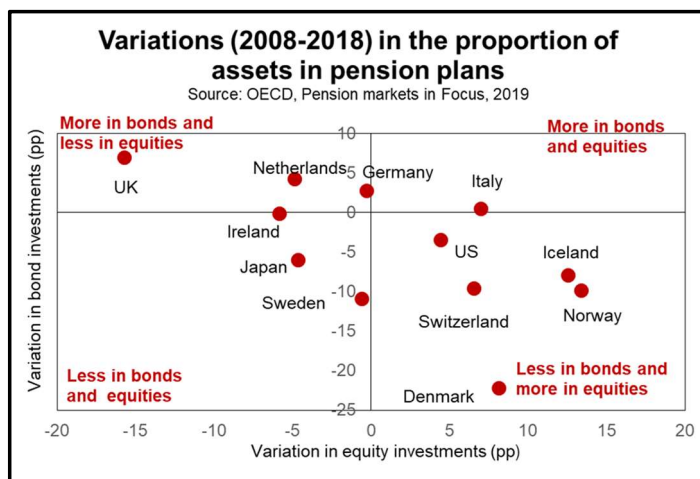
Source: Aegon Asset Management, 2019

- **A need for a change of strategic asset allocation decisions or an increase in pension contributions rate**: deteriorating funding ratios could push the debate towards asking for less strict solvency rules in order to permit pension fund managers to invest in riskier assets (such as equity) to narrow the gap.

According to OECD data (2018), in the last 10 years Dutch pension funds experienced a contraction of investments in equities in favor of bonds, due to higher Solvency constraints imposed by regulation.

However, since pensioners and future pensioners will (individually) bear more of the risk, and an easing of the Solvency rules seems unlikely, the re-risking scenario is, at least, uncertain. If the asset allocation remains unchanged, the committee said it expected that the new parameters (for the new assumptions on asset class returns) would lead to a **rise in pension contributions** of at least 3%.





On the Product design side, even it is unclear whether all pension funds are required to switch to the new contract or have the option to do so, the proposed changes could result in:

- A shift in the demand for risky assets towards younger generations, according to the lifecycle model. It is still unclear how this could fit in the actual Solvency regulation framework. This could affect the implicit redistribution mechanism between young and old workers, making it more exposed to financial markets volatility.
- Bigger pooling effects² during the de-cumulating phase against, for example, longevity risk.

The overall reform process should take at least 3 years to be operative but, up to now, a number of non-negligible details are still to be approved by the Dutch Parliament.

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² Risk pooling is the collection and management of financial resources so that large, unpredictable individual financial risks become predictable and are distributed among all members of the pool.

Imprint

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