Why the Dutch pension system is not a role model for the UK

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The UK should not look to the Dutch when thinking about how to improve pension policy, argues ***David Hollanders****. Suboptimal governance, high costs and decreasing benefits has characterised the Dutch system of late. Nevertheless, the Dutch system serves as a good example for why collective action is a necessary antidote against deregulated financial institutions.*

In a speech on June 4th Queen Elizabeth praised the Dutch pension system as an example for the UK. The royal praise – no doubt instigated by civil servants – is flattering indeed for the Dutch, but it is alas not justified. The English should be careful what they wish for. Increasingly the Dutch system has become an example how not to organise pensions. In the last two decades the Dutch pension system has turned into a profit-driven, financialised sector, characterised by high costs, high risks, increasing management layers, yet ever decreasing pension benefits.

But to start on a positive note, on several counts the Dutch system performs comparatively good. The pension system in the Netherlands consists of three pillars. The first pillar is a public flat-rate pension and avoids outright poverty in old age. The second pillar provides retired workers with additional income from work-related supplementary pension plans. The third pillar consists of tax-deferred voluntarily personal savings.

The praise is exclusively directed at the second pillar. This has some good reasons, or so it seems at least. The assets saved are a staggering one trillion euro, relative to GDP (160 per cent) the highest in the OECD. The (theoretical) replacement rate is 91.4, the highest in the OECD. The coverage ratio is around 90 per cent, again among the highest. While this comes at the expense of the system being mandatory, the alternative of free choice is irreconcilable with Defined Benefit-plans. And DB-system are – or were – the cornerstone of the Dutch pension system. This is the plan preferred by most employees. It provides a predictable income stream and – far more importantly– it ensures that risks, be it investment risk, inflation, high costs or even fraud, do not lie with participants but lie with sponsoring companies, pension funds and asset managers.

This all changed in the mid-nineties. In 1996 the pension fund for civil servants, the largest pension fund of Europe in absolute terms, was privatised. In 2007 all large pension funds were separated in a small fund that remains legally responsible for pension plans and large commercial entities that bear no direct responsibility and are not regulated by the Central Bank. These large entities invest the assets, undertake administration and marketing and advise the small pension fund. The consequences of this financialisation of pensions – until the nineties seen and treated as deferred wages, to be organized by social partners – have been dire.

First, outsourcing increased, with 89 per cent of the pension funds nowadays outsourcing at least 30 per cent of their asset management. Second, it led to a surge in costs, which are now equal to 6 billion euro, the main cost category being asset management. To put this in perspective, this is around 17 per cent of contributions. Third, the risk-level increased. In 1980 3 per cent of pension assets were invested in equity. This was already 13 per cent in 1990, and increased to 48 per cent in 2000; in 2010 it was 56 per cent.

Until 2008 many participants thought cost-, risk- and management-layer-increasing privatizations were defendable – or they just didn’t care- as pensions remained intact. In 2008 the financial position of funds however deteriorated. The main reason was that even well-capitalised pension funds hadn’t hedged interest rate risk (which they should have as liabilities are highly interest rate-sensitive). The only reason *not* to do so, is that such hedges –primarily by investing in fixed-securities- do not need many investors and do not render large bonuses. To cut a long story short, the DB-plan turned out not to be, well, defined after all. Pensions were decreased by many funds with an average cut of 10 per cent in 2009-2014.

This contrasts with employers who generally didn't increase their contributions (which the supervisor condoned). This is striking on several counts. First, in many cases there is a legal obligation to do so. Second, employers didn't pay their full share in the nineties (a fact obfuscated by high returns); as the economist Nicholas Barr puts it "a cynical view is that in corporate plans the firm creams the surplus in good times and reneges on pension promises in bad times." Third, employers are represented on the board under the premise that they are risk-bearers but in actuality turn out not to bear any risk.

To sum up, suboptimal governance, high costs and decreasing benefits hardly form a role model, even if official statements keep calling it a DB-system. This is not to say that it couldn't be worse, as the UK knows best itself. The Netherlands avoided in the second pillar misselling scandals like in the UK but not in the third). The reason is the collective nature of Dutch pension plans. It is easier to renege on a million of different promises than to renege on one promise to a group of millions of people. The latter stirs more discussion in parliament and media than the first. A new party explicitly representing interest of older people (over 50) even entered the Dutch parliament in 2012. The Dutch system serves as a good example why collective action is a necessary antidote against deregulated financial institutions. But the way pension funds and their asset managers operated the last decades is only reason for concern not praise.

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