Mandatory and voluntary participation in occupational pension schemes in the Netherlands and other countries

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based on joint articles with

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Overview of presentation

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1. Motivation

- Reasons for mandatory participation
  - Myopic saving
  - Cost efficiency
  - Risk-sharing

- Dutch employees:
  - >90% participates in an occupational pension scheme due to mandatory participation (only Small Mandatory Participation)
  - >75% participates in an occupational pension scheme due to mandatory participation (Small and Large Mandatory Participation)

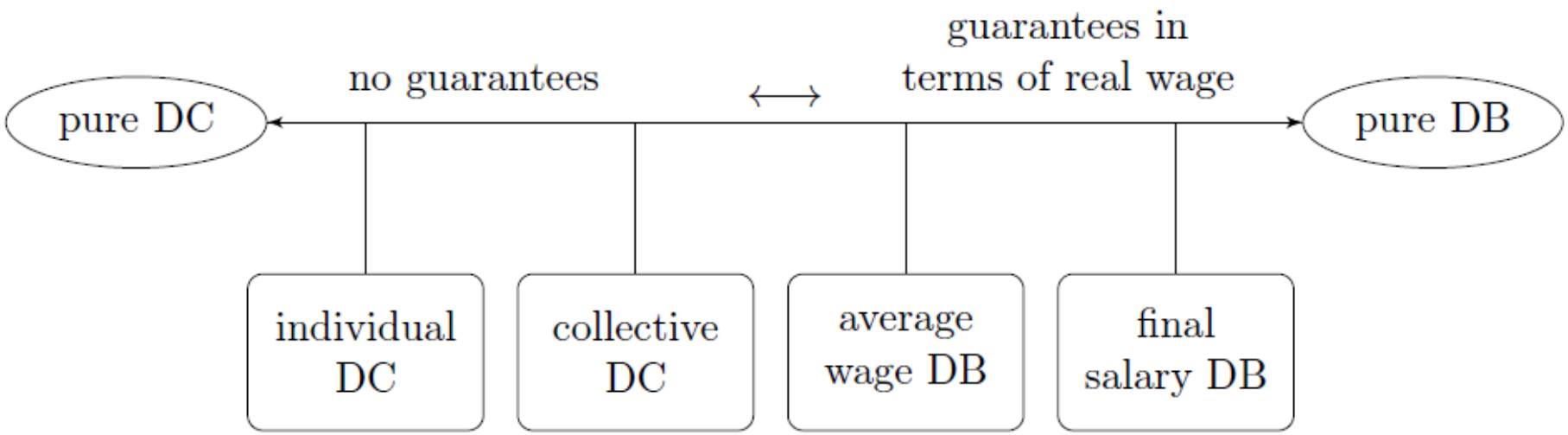
- Developments EU and NL → potential consequences for mandatory participation

- This paper: overview and developments pension scheme in the NL and other countries, particular attention is given to mandatory participation

2. Classification of pension arrangements

- PAYG vs funded pension schemes
- DB (Defined Benefit) vs DC (Defined Contribution)
- Actuarial fairness (link between contribution and benefit)
- Management of the pension scheme (government vs private entity)

2. Classification of pension arrangements



3. Overview Dutch pension arrangements

- First pillar: social security (known as “AOW”)
- Second pillar: supplementary occupational pensions
  - Small and Large Mandatory Participation
- Third pillar: supplementary individual pensions

3. Overview Dutch pension arrangements – first pillar

- Known as “AOW”: pension rights are acquired during legal residency in the Netherlands. Also non-employed are eligible.
- Financing: PAYG through tax on income.
- Mandatory features: contributions via the tax system are obligatory for all employed Dutch residents who have not reached the legal retirement age.

3. Overview Dutch pension arrangements – second pillar

- For employees who have to participate in the pension plan offered by their employer:
  - Mainly pension funds: mostly DB
  - Insurance companies or banks: mostly DC
  - Premium Pension Institution (PPI): only DC
- Financing: funded pension plans, both DB and DC arrangements.
- Mandatory features: the “Small Mandatory participation” and the “Large Mandatory Participation” (next slide), but no legal obligation.

3. Overview Dutch pension arrangements – Small and Large Mandatory Participation

- *Small Mandatory Participation*:
  Employers in some sectors and professions are obliged to participate in a pension plan, upon request of social partners.

- *Large Mandatory Participation*:
  Employees are obliged to participate in the pension plan provided by their employer(s).

3. Overview Dutch pension arrangements –third pillar

- Individual pension accounts; supplementary to first (and second) pillar pension
- Financing: funded, DC / capital insurance / life insurance (type of DB, not very common as it is relatively expensive).
- Mandatory features: none.

4. Justification mandatory participation – economic

- Myopia and lack of self control of working cohorts
- Economies-of-scale and absence of marketing cost and profit motive
- Intergenerational risk sharing – case of Netherlands:
  - Bad shock leads to increased contribution rates (risk-sharing among all working cohorts) and reduced indexation (risk sharing among all cohorts)
  - Vice versa, for good shock

4. Sustainability of pension systems

- Once large groups loose confidence in a pension system, it is bound to collapse, as political pressure to relax the participation requirement becomes too large

- In Beetsma, Romp & Vos (2012) and Beetsma & Romp (2013) we focus on the insurance motive of entry decision of young participants

4. The decision of new participants

- Value of participation is determined by
  - Uncertainty and risk aversion of the participants
  - Price of the insurance (contribution rate, including possible deficits)
  - Pension when retired
  - Probability of actually receiving the pension

- Young participate as long as exp. gains exceed the exp. costs, but…
  - Insurance is paid for by future generations
  - The value of the insurance depends on their willingness to participate
  - So willingness to participate of ***current*** generations depends on their expectation about willingness to participate of ***future*** generations

4. The decision of new participants

- We solve this chicken and the egg problem by focusing on the 'symmetric' solution
  - Every future generation has same maximum contribution above which they refuse to participate
  - A maximum contribution is an equilibrium if current generation is just willing to participate when they have to pay this contribution and they expect that the next generation also uses this threshold.

4. Implications

- It is only possible to create PAYG pension system or funded system with buffers if first participants expect next generations also to participate (sense of solidarity)

- Current situation is ‘a perfect storm’ for a funded DB pension system
  - Low funding rates require excess contributions, which are also used to restore buffers and to pay out pensions of currently retired
  - High old-age dependency ratios, so current funding gaps have to be covered by a small group and burden of future risks rests also on this small group of active participants
  - Less confidence that future generations are also willing to participate

- Buffers may even worsen the situation
  - Buffers make required contribution more volatile

4. Justification mandatory participation – legal

- Small Mandatory Participation: does not violate Competition Law
- Large Mandatory Participation: also does not violate Competition Law according to jurisprudence
- Jurisprudence: justified because of *nature* and *purpose*
- Nature: collective agreement
- Purpose: solidarity
- Comparison: current / forthcoming / fictitious pension contract

4. Justification mandatory participation: current contract

- Agreement between social partners and employees (*nature*)

- Collective agreement (*nature* and *purpose*)

- High degree of solidarity (*purpose*):
  - Uniform contribution rate
  - Uniform accrual rate
  - Uniform indexation workers and uniform indexation sleepers and retired
  - Nominal guarantees (DB-elements)
  - No adverse selection

→ Mandatory participation justified

4. Justification mandatory participation: fictitious contract

- Individual (DC) arrangements (*nature*)
- No risk-sharing between participants (*purpose*)
- Switching between funds allowed (*purpose*)

→ Mandatory participation *not* justified

5. Developments Dutch pension arrangements

- Population ageing and financial crisis: funding ratios ↓
- Final-salary based scheme → average-wage based scheme
- Indexation of pension rights ↓
- Retirement age ↑
- Minimum (cost-covering) contribution rate
- Revised supervisory framework (known as “FTK”)
- Threshold for tax exemption (known as “Witteveenkader”) ↓

5. Developments Dutch pension arrangements – Financial sustainability

- Mercer Global Pension Index looks at ≤ 20 countries based on:
  - Adequacy
  - Sustainability
  - Integrity

- The Netherlands scores well (1st in 2009-2011, 2nd in 2012 and 2013)

- But: score is decreasing, while reforms are necessary (sustainability)

- What are the potential consequences for the mandatory participation as a result of reforms?

6. Developments pan-European pension market

- IORP II Directive
  - IORP: Institutions for Occupational Retirement Provision
- Cross-border pension products. In the Netherlands:
  - Premium Pension Institution (PPI)
  - General Pension Institution (API) (not existing yet)

6. IORP II Directive

- Stimulate integration of European pension market
  - Stimulating market competition
  - Cross-border pension products (NL: PPI and API)
- Solvency II-type of supervisory framework
  - Larger buffer requirements
  - Shorter recovery period
  - For the time being Solvency II will not be applied to IORPs (Barnier)

6. Cross-border pension products – PPI and API

- Enhancing competition by stimulating cross-border pension product provision

- Obstacles in Dutch law
  1. domain delineation: funds cannot operate in another sector
  2. no ring-fencing: single financial unit
  3. governance requirements: governance by social partners

- Implementation API in 3 phases:
  1. PPI: cross-border DC pension product
  2. Multi-CPF: ring-fencing and domain delineation
  3. Replacement multi-CPF by API and changes in governance requirements

6. Cross-border pension products – PPI and API

- Intermediate step (between 2 and 3) has recently been announced (Nov 2013):
  - Replacement multi-CPF by “Multi pension fund”
  - Multi pension fund is not cross-border, but a step towards the API, as obstacles to cross-border operations by pension funds are abolished

- API will be worked out further when IORP II Directive is completed
  - API is particularly interesting for multinationals

- Multi pension fund and API: also for pension funds with Large Mandatory Participation? Complications:
  - Anonymous buffer (particularly DB)
  - Justification mandatory participation may become weaker (solidarity)

7. Mandatory participation in new contract

- Potentially less risk-sharing (*purpose*):
  - Link between retirement age and life expectancy
  - Link between minimum required contribution rate and yield curve
  - Limited smoothing period of shocks (Mehlkopf, 2013)

- Possible consequences Multi pension fund/API/IORP II Directive (*purpose*):
  - More market competition
  - Switching between funds allowed?
  - Benefits more tightly linked to contributions

→ Justification for mandatory participation may become weaker

8. Other countries

- Australia, Chile, Iceland, Sweden and Switzerland
  - Mandatory by law for all employed/employees.

- Denmark and the Netherlands
  - Quasi-mandatory for most employers and employees through collective agreements.

- U.K. and the U.S.
  - Not mandatory, but policies exist to stimulate participation in a supplementary pension scheme.

8. Other countries

Table 3: Financing of and benefits from the first pension pillar

	Type of financing	Benefit
Australia	general revenues	means-tested
Chile	general revenues	means-tested
Denmark	general revenues and social security tax	means-tested and income-tested
Iceland	social security tax	means-tested
the Netherlands	social security tax	flat rate
Sweden	general revenues	means-tested
Switzerland	social security tax	income-tested
U.K.	social security tax	income-tested
U.S.	social security tax	income-tested

8. Other countries

Table 4: Financing of the second pension pillar

	Financing (DC - DB)[a]	Contribution rate[b]
Australia	funded (81% - 19%)	minimum of 12%
Chile	funded (in principle DC, but de facto partly DB, due to minimum guarantees)	minimum of 10% (administrative fees not included)
Denmark	funded (95% - 5%)	average of 10.8%
Iceland	funded (mandatory part DB, remaining part 80% - 20%)	minimum of 4% (for the employer: minimum of 8%)
The Netherlands	funded (7% - 93%)	average of 6.2% on earnings above a threshold (for the employer: average of 11.3%)
Sweden	PAYG (mostly notional DC; small part DC and DB)	mandatory 9.25% (also for the employer: mandatory 9.25%)
Switzerland	funded (60% - 40%)	mandatory 3.5%-5%-7.5%-9% from youngest to oldest age class (also for the employer: mandatory 3.5%-5%-7.5%-9%)
U.K.	funded (39% - 61%)	minimum of 2%, but will be increased to 8% (for the employer: minimum of 1%, but will be increased to 3%, for the government: 1%)
U.S.	funded (57% - 43%)	average of 9%

8. Other countries

Table 6: Participation in the second pension pillar

	Participation
Australia	mandatory for all employees
Chile	mandatory for all employees; however, only 60% participates; soon also mandatory for self-employed
Denmark	quasi-mandatory for most employers and employees through collective agreements
Iceland	mandatory for all wage earners
The Netherlands	quasi-mandatory for most employers and employees through collective agreements
Sweden	mandatory for all wage earners
Switzerland	mandatory for all wage earners
U.K.	employers are obliged to enrol employees into a pension fund; employees are allowed to opt out
U.S.	voluntary; however, 60% of employees can participate in an employer-sponsored plan and 80% of these employees decide do so

9. Concluding remarks and remaining questions

- Good economic reasons for mandatory pension participation
- However, financial pressure and legal developments (domestically and EU) are putting mandatory participation under pressure
- What is the scope for voluntary participation in DB funded schemes?
- What are potential consequences of the introduction of the Multi pension fund?
  - Conversion of sector fund into a Multi pension fund or an API?
  - Anonymous buffer (DB)
  - Solidarity may be undermined, affecting the obligation to participate