The Dutch Pension System

an overview of the key aspects

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Dutch Association of
Industry-wide Pension Funds (VB)

Opf
Dutch Association of Company Pension Funds

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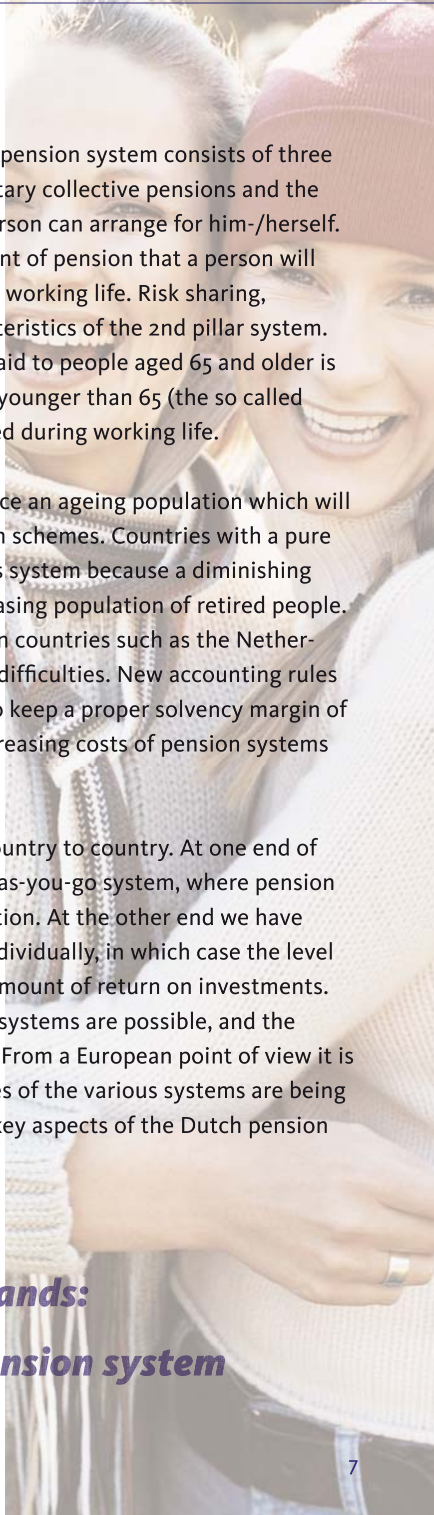
1 Introduction



As in many other European countries, the Dutch pension system consists of three pillars: the state pension (AOW), the supplementary collective pensions and the private individual pension products that each person can arrange for him-/herself. Together these three pillars determine the amount of pension that a person will receive when he/she retires at the end of his/her working life. Risk sharing, efficiency and collective schemes are key characteristics of the 2nd pillar system. The Dutch state pension (AOW) benefit that is paid to people aged 65 and older is funded by contributions that are paid by people younger than 65 (the so called pay-as-you-go system). Pension rights are accrued during working life.

The Netherlands as all the European countries face an ageing population which will have a major impact on the design of the pension schemes. Countries with a pure pay-as-you-go system foresee problems with this system because a diminishing working population has to support an ever increasing population of retired people. This calls for far-reaching reforms. However, even countries such as the Netherlands with a second pillar that is funded foresee difficulties. New accounting rules and new rules for technical provisions in order to keep a proper solvency margin of the schemes as well as an ageing society and increasing costs of pension systems may result in the reduction of pension benefits.

In Europe, pension systems differ largely from country to country. At one end of the spectrum we have countries with only a pay-as-you-go system, where pension benefits are fully paid for by the working population. At the other end we have countries where people save for their pension individually, in which case the level of pension benefit is largely determined by the amount of return on investments. However many combinations of these two basic systems are possible, and the Netherlands in fact do have such a combination. From a European point of view it is important that the advantages and disadvantages of the various systems are being considered. We have therefore summarised the key aspects of the Dutch pension system.

The Netherlands: unique pension system

2 The Three Pillars of the Dutch Pension System

As stated above, the Dutch pension system consists of three pillars. Depending on a person's personal situation, a retired person will receive a benefit from the first pillar, or from the first and second pillars, or from the first and third pillars or from all three pillars.

2.1 First Pillar

The first pillar is the state pension (AOW). The General Old Age Pensions Act came into force in 1957 and is the foundation for old-age pension benefits.
The state pension provides a basic income, the level of which is linked to the statutory minimum wage. Married couples and couples living together each receive 50% of the minimum wage (approximately € 700 gross per month). Pensioners living alone receive more, 70% of the minimum wage (approximately € 1000 gross per month). Everyone who has lived or worked in the Netherlands between the age of 15 and 65 has a state pension and a right to state pension benefit from the age of 65. 2% of the state pension benefit is accrued for each year that someone between 15 and 65 years and who lives in the Netherlands is insured for. Even those who do not work accumulate state pension rights. At the end of 2007, 2.7 million people received Dutch state pension benefits at a total amount of
€ 25.2 billion.
In comparison to other countries the Dutch state pension provides only a limited part of all old-age benefits.

The first pillar is a pay-as-you-go system. This means that the costs of the Dutch state pension benefits are paid by the workforce in the form of contributions. Additional funding for the Dutch state pension comes from government public funds. So directly or indirectly, everyone contributes to the increasing state pension costs, whether they work or are retired.

2.2 Second Pillar

The second pillar consists of the collective pension schemes. These pension schemes are administered by a pension fund or by an insurance company. Under Dutch law, company and pension fund are strictly separated. Pension funds are legally and financially independent from the companies. Most pension money in the Netherlands is managed by pension funds.
The second pillar is financed by capital funding. This means that the pensions are financed from the contributions members of the scheme paid in the past and from the return on the investment of these contributions.

In the Netherlands there are three different types of pension funds:

- Industry-wide pension funds (for a whole sector, such as the civil service, construction industry, hotel and catering industry or the retail sector),
- Corporate pension funds (for a single company or a corporation),
- Pension funds for independent professionals such as medical specialists and dentists.

Pension funds are non-profit organisations. Operating as foundations they are independent legal entities and do not form part of a company. The pension funds will therefore not be directly affected if a company gets into financial difficulties.

Mandatory nature

In the Netherlands there is no obligation by law to become a member of a pension fund. But if the social partners decide to provide a pension scheme for their employees, the government can make a pension scheme mandatory for an entire sector or profession. Thus, more than 90% of employees have a pension scheme with their employer. In such a case, an employer is no longer free to decide for himself whether or not to offer a pension scheme to his employees.
The mandatory nature ensures industry-wide pension funds with sufficient economies of scale, enabling cost efficient management of the schemes. Furthermore the mandatory nature means that all employees are members of a good pension scheme. The government wants to create solidarity through compulsory participation. In addition it means that employees can change jobs more easily within the sector without this having an impact on their pension.
Companies that do not fall under such a mandatory scheme can opt either for a corporate pension fund or for an insurance company to manage their pension scheme.

Pension Fund Organisation

The features of the pension scheme are determined by employers and employees, and this is the case for both corporate as well as industry-wide pension funds. Policy is determined by the fund's board of trustees. The board of trustees consists by law of employer and employee representatives in equal representation.
In a corporate pension fund some retired members can take up the employee seats on the board.

A limited number of pension funds manage the pension fund and the portfolio management themselves. However, most funds contract this out to an external implementing body which may be an insurance company or a specialised pension scheme administrator. These are private organisations with or without profit motive.

Facts and figures about the 2nd pillar pension funds

More than 90% of employees belong to a pension fund. At the end of 2008 there were about 600 pension funds in the Netherlands. In addition employers have signed some 22,000 pension agreements with insurers for more than 800,000 employees.
Three-quarters of all employees are with an industry-wide pension fund. Other employees are with a corporate pension fund or an insurance company.
The size of the pension funds varies considerably, as far as the number of members is concerned as well as the accrued capital. The largest fund in the Netherlands has more than 1 million active members and an invested capital in excess of € 150 billion. But there are also funds with less than 100 members and an invested capital of just a few million Euros.

At the end of 2008, pension funds in the Netherlands managed an invested capital of about € 700 billion. In comparison, the Dutch Gross National Product in 2008 was approximately € 600 billion.

Pension fund administration costs

Costs incurred by the Dutch pension funds are relatively low. This is mainly due to the economies of scale and the fact that pension funds do not have a profit motive. Working with standard contracts where there is little room for individual choice also keeps the administration costs low.

Administration costs differ from pension fund to pension fund. In the Netherlands the average costs amount to about 3.5% (2004) of the contribution. This means that almost all the contribution goes towards building up pension benefits. The situation with life insurance companies who offer individual annuity insurance is quite different. These organisations incur marketing costs in addition to administration costs. Furthermore, commercial insurers are expected to make a profit. As a result of this accumulation of costs, a life insurance company can spend 25.7% (2004) of the premiums on matters other than building up pension benefits.[1]

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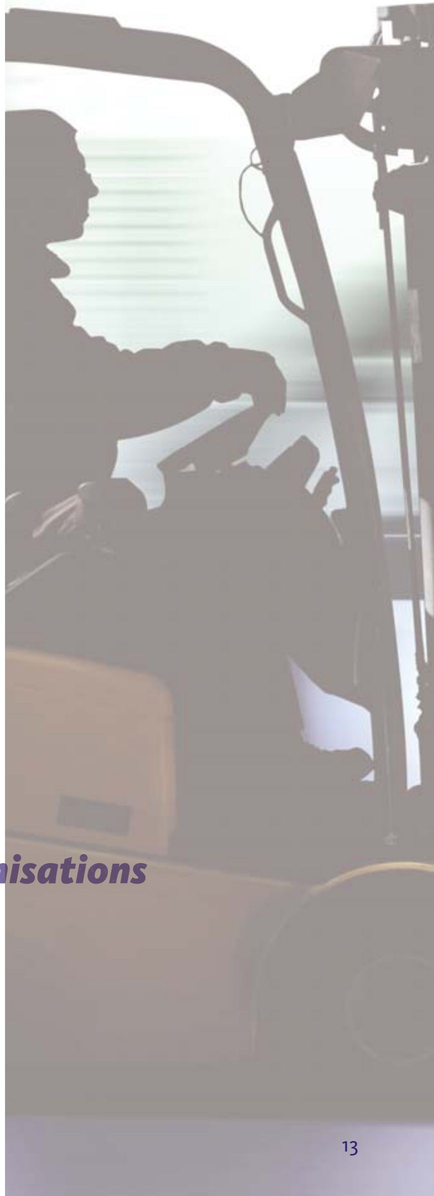
[1] Steenbeek, O., S.G. van der Lecq (ed.) Cost and benefits of group pension systems, Hoofddorp 2006

2.3 Third Pillar

The third pillar is formed by individual pension products. These are mainly used by the self-employed and employees in sectors without a collective pension scheme. Anyone can purchase a product in the third pillar to meet his/her requirements. In this way, people can save extra pension, often taking advantage of tax benefits.



pension funds are non-profit organisations

3 Regulation

The government keeps an eye on the goings-on of pension administrators. This task is delegated to two regulators, the Dutch Central Bank (DNB) and the Dutch Authority for the Financial Markets (AFM).

3.1 Dutch Central Bank (DNB)

The Dutch Central Bank (DNB) examines the financial position of the pension funds. DNB assesses whether the pension funds are financially healthy and whether they can be expected to fulfil their obligations in the future. The DNB is also responsible for substantive regulation, such as monitoring that pension funds comply with the standards set for them. The DNB regulates the pension fund and not the implementing body. Final responsibility for administering the pension scheme rests with the pension fund, even though the daily administration rests with the implementing body.

Financial Assessment Framework (FTK)

A pension fund must always have sufficient liquidities available to pay the pensions. The Financial Assessment Framework, which is part of the Pensions Act, sets out the requirements for the financial position of a pension fund. A pension fund's financial position is reflected largely by the coverage ratio. This expresses the relationship between the fund's assets and the pensions to be paid in the future (pension liabilities).

The minimum coverage ratio is 105%. This means that the capital must amount to 105% of the liabilities. In addition a pension fund must hold enough buffers (equity) to be able to cope with financial setbacks. The size of these buffers depends on many factors, but for an average pension fund the required coverage ratio including the required buffers is approximately 125%. The greater the investment risks and the higher the average age in the pension fund, the higher the buffer requirements. The fund's capital as well as the liabilities are valued at market price.

Recovery plan

If there is a funding shortfall (coverage ratio less than 105%), the fund must submit a recovery plan to the DNB. The coverage ratio must regain the 105% level within 3 years. A fund subsequently has a total of 15 years in which to rebuild the required buffers. In exceptional circumstances the 3-year recovery period may be extended. This occurred recently (extension to 5 years) as a result of problems related to the credit crunch.

3.2 Netherlands Authority for the Financial Markets (AFM)

The Dutch Authority for the Financial Markets (AFM) monitors the behaviour of pension funds, in particular regarding the obligations to provide information to members. The AFM also monitors the duty of care; pension funds, who offer pension products with freedom of investment, must actually provide this investment support to their (former) members.

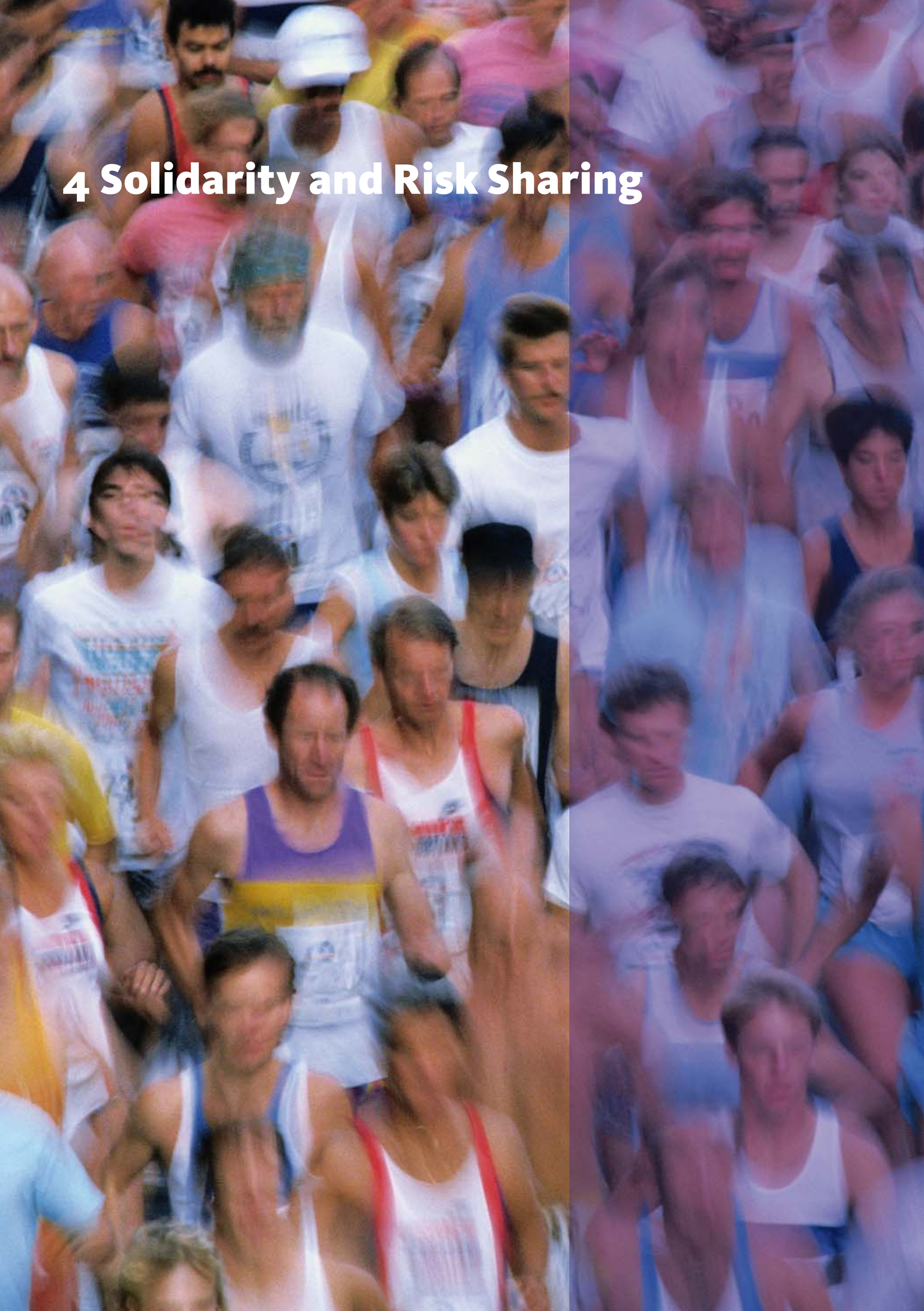
Obligations to provide information

Under the Pensions Act, pension administrators are obliged to properly inform the people for whom they manage the pension or to whom they pay the pension benefits about their pension rights. This helps people to properly assess their financial situation and to make the right choices for their retirement. This is useful if people think they will not have sufficient income to live on after their retirement or wish to take early retirements or would like to spend some time abroad. In these circumstances people can make a conscious choice to supplement the income they can expect from the first and second pillars.

For example, the Pensions Act states that people must receive information in writing when joining the pension scheme and they must receive an annual pension statement. It also specifies at which points in time information must be provided and that this information must be written in clear language. The Pensions Act also specifies that the pension administrators must establish and manage a joint register of pensions from 2011. This register is designed to enable members, deferred members and former partners to gain insight into their pension entitlements in a simple manner via internet.

conduct and financial affairs monitored closely

4 Solidarity and Risk Sharing



4.1 Solidarity

In the Dutch collective supplementary pension system a member each year builds up future pension rights equivalent to a fixed percentage of the salary. All members pay the same contributions to the pension fund. Individual differences such as age, gender, health and income are not taken into account when determining the amount of contribution to be paid. For example, on average women live for longer than men, but they do not pay higher contributions than men. Another aspect of the solidarity is that medical examinations on joining the pension scheme are not permitted.

4.2 Risk Sharing

The majority of the Dutch DB (Defined Benefit) pension schemes are in fact not pure DB schemes, but are hybrid schemes. This means that if a fund gets into financial difficulties, all parties involved, employer, employees and those drawing their pension, contribute to the recovery.

- The pension contributions can be increased. This will increase the wage costs for the employer and decrease the net salary for the employee. Another option is that the employer commits paying the extra contributions required to incidentally pay an extra contribution.
- The indexation can be limited. Most pension schemes include a clause stating that indexation is conditional. Each year the pension fund's executive board will decide whether the fund's financial position will permit indexation of the pensions and accrued rights. In indexed average salary schemes such indexations constraints affect pensioners, members still contributing and early leavers.
- An extreme measure is to reduce the pension rights.

In many pension schemes the contribution amount as well as the level of indexation depends on the coverage ratio. This is known as intergenerational risk sharing for pension funds. Furthermore, when determining the investment mix a balance must be found between the needs of those drawing a pension for security and on the other hand, the needs of the younger contributor for the opportunity to achieve a good return on investment.

4.3 Accountancy Regulations

In times of economic crisis, if the coverage ratio is less than 105%, employers, employees and pensioners are asked to make sacrifices. The accountancy regulations for Dutch unlisted companies take this into account. The level of pension liabilities on the balance sheet depends on the contract they have agreed with the pension fund. Risks that the company itself must take (in the degree to which the risks are taken) must also be included on the company balance sheet. The company's obligation can be limited contractually to no more than paying the contributions. In which case, based on the Dutch regulations (RJ271), the company balance sheet does not have to include any supplementary pension liabilities. This in contrast to the international accountancy regulations, set out in IAS19, whereby companies quoted on the stock exchange with their own corporate pension fund must show the total pension liabilities in the company's annual accounts, even though the risks are shared between the members, deferred members and the employer.

considerable solidarity

due to flat-rate contributions

5 Different Types of Pension Agreements

5.1 DB Schemes

There are various forms of pension schemes. The most common is the so-called "salary scheme", also known as Defined Benefit schemes (DB). In these schemes, the level of pension depends on the number of years worked in combination with your salary.
DB schemes can be divided into final salary schemes and average salary schemes. In the Netherlands, the majority of pension schemes are DB schemes. In recent years many of these schemes have been converted from final salary to average salary schemes. At the end of 2008 only 1% of the active members had a final salary scheme, 87% have an average salary scheme and 5% a DC scheme (see below). The other schemes are a mixture of different types of schemes.

In final salary schemes, the accrued pension rights are increased at each career step to the level of the new pension basis. If the average salary is the pension basis then this is known as an average salary scheme. In average salary schemes, the accrued pension rights are related to the employees' income in a specified year.
In general, average salary schemes have conditional indexation. In principle, this means that the pension rights of employees as well as those already drawing their pension are revised annually for inflation or increase in wages in the sector. If the fund's financial situation is such that an adjustment is not feasible, then it will not be applied, and this is why it is referred to as conditional indexation.

Pension funds do not have to maintain reserves for future indexation. However, pension funds must demonstrate to the regulator that they will be able to realise their indexation plans in the long-term. Based on an indexation table the pension administrators indicate to what extent they will be able to keep abreast with inflation under normal circumstances and what will happen if they are faced with a severe economic downturn.

5.2 DC Schemes

In addition to Defined Benefit schemes there are also Defined Contribution (DC) schemes, where the amount of pension a person receives depends on the contributions paid during the accumulation period and the return on investment achieved with those contributions. Individual DC schemes are not very common in the Netherlands. The capital must be converted to an annuity on or before the retirement date. In principle, the investment risk and the interest rate risk (the risk that the rate for purchasing an annuity changes) rest with the employee.

It is also possible that a pension scheme is a combination of the systems mentioned above. For example, a person may have a retirement pension that consists of a combination of a DB scheme (up to a certain salary level) and a DC scheme to supplement the retirement income above this level.

5.3 CDC Schemes

In the Netherlands there are also hybrid schemes in addition to the DB and DC schemes discussed above, these are the so-called Collective Defined Contribution (CDC) pension schemes. In these schemes the amount of pension is based on salary and the number of years a person participates in a scheme, as if it were a DB scheme. However, the contributions are fixed for many years. If it transpires that the contributions are insufficient, then the pension benefits will be lower than originally envisaged. CDC schemes combine a limited risk for fluctuating pension commitments for the employer with the advantages of a collective pension scheme.

ambition: pension grows

with salary development or inflation

6 Miscellaneous

6.1 Employee participation

The Pensions Act also dictates how a pension fund is to be administered.

- The board of trustees must be made up of employer and employee representatives in equal proportions. The board of trustees must serve the interests of all stakeholders. These are active members and the employer, as well as pensioners and deferred members.
- An industry-wide pension fund has a members' council where the employees and pensioners are proportionally represented. The members' council makes recommendations to the executive board about all major affairs. A members' council is not mandatory for a corporate pension fund or occupational pension fund. In the case of a corporate pension fund, if there is no members' council, then the pensioners must be represented on the executive board directly.
- The board of trustees must establish internal supervision that periodically assesses whether the administrative processes and the management of the fund are operating properly.
- The board of trustees must report to an accountability body that consists of representatives of all stakeholders, employers, employees and pensioners.

6.2 Ageing population

The statutory retirement age is currently 65 years. In the Netherlands, fiscal support for pension contributions paid to enable retirement before the age of 65 was terminated several years ago. It is still possible for people to take early retirement, but they must finance this themselves: if a person wishes to have his/her retirement pension paid from a younger age, then the pension will be considerably lower, because the accrued pension capital will have to last for longer.

It is also possible to work longer and retire after the age of 65. In recent years the statutory obstacles to working beyond 65 have been removed. Postponing retirement reverses the effects of early retirement. It is financially attractive. By working longer, more pension rights are built up, the pension benefit commences at a later stage and this means that the pension can be higher. In general the amount of pension payable will increase by about 9% for every year a person works after the retirement date. Postponing the retirement date can therefore quickly lead to a considerable increase in pension benefits and is an attractive means of solving the problem of any pension shortfall.

Often a pension scheme will offer the option of part time retirement. In this case a person receives salary for the days worked and pension benefits for the rest of the week. So it is still possible to build up pension rights for the part of the week still worked.

6.3 Taxation

In the Netherlands, the pension accumulation period is stimulated through taxation measures. No tax is levied on pension contributions. And the growth of pension rights via the pension fund's investment performance remains untaxed. Pension benefit is only taxed when it is received, known as the reversal rule. This delay in paying tax is even more attractive because the tax rates payable over the future pension benefit will be lower than the tax rates applicable to current income. These tax advantages are a major reason as to why more than 90% of employees in the Netherlands are having a company pension. The Dutch pension system also helps to increase awareness that it is wise to start preparing financially for retirement during your active working life.

6.4 Commutation prohibited

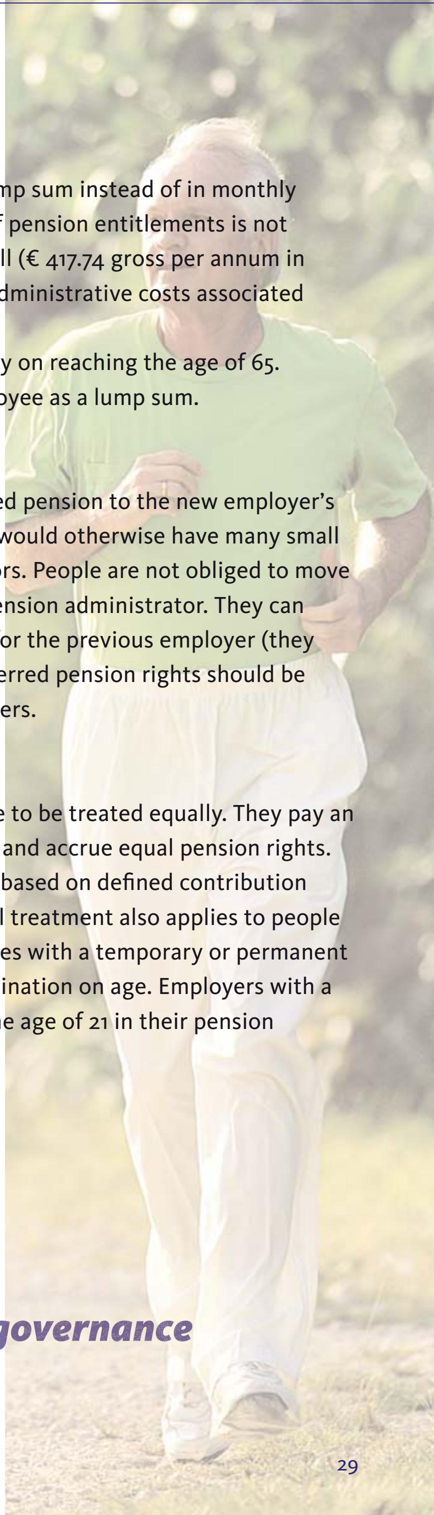
Commutation is when the pension is paid in a lump sum instead of in monthly instalments. In the Netherlands, commutation of pension entitlements is not permitted, unless the annual amount is very small (€ 417.74 gross per annum in 2009). The reason for this is the relatively high administrative costs associated with a small pension.
For DC schemes it is mandatory to buy an annuity on reaching the age of 65. The pension capital may not be paid to the employee as a lump sum.

6.5 Transferring pension rights

People who change jobs can transfer their accrued pension to the new employer's pension fund. People who change jobs regularly would otherwise have many small pension rights with several pension administrators. People are not obliged to move their accrued pension to their new employer's pension administrator. They can choose to leave it in the pension fund managed for the previous employer (they then have deferred member pension rights). Deferred pension rights should be indexed in the same way as the rights of pensioners.

6.6 Equal treatment

The Pensions Act states that men and women are to be treated equally. They pay an equal percentage of their salary in contributions and accrue equal pension rights. Since 2005, pension benefit payments which are based on defined contribution schemes are the same for men and women. Equal treatment also applies to people who work part time or full time, and for employees with a temporary or permanent contract. The Pensions Act also prohibits discrimination on age. Employers with a pension scheme must include employees from the age of 21 in their pension scheme.



focus on

corporate governance

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