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The Dutch CDC pension reforms: Some key takeaways as the UK begins its own CDC journey

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The Netherlands consistently ranks as a global leader for pension provision. Despite this success, the country has been debating pension provision for many years, culminating in a new pensions law which requires pension funds to transition to one of two new Collective Defined Contribution (CDC) flavours. This article explains what the reforms entail and sets out some key takeaways for the UK as it embarks on its own CDC journey.

Executive summary

- Dutch pension funds are undergoing large-scale reform: some of the largest pension funds in Europe will convert members' accrued pensions into individual pension pots.
- Employers and work councils have a choice of two flavours of CDC: a Solidary Pension Arrangement (SPR) and a Flexible Pension Arrangement (FPR).
- The solidary arrangement will maintain collective investments but with returns distributed between members' individual pots according to a novel glidepath mechanism.
- The flexible arrangement will look more like individual DC but with longevity risk-pooling (or insured annuities) after retirement.
- Under both arrangements, contribution percentages will become age-independent and the law requires members disadvantaged by the transition to be compensated.
- The reforms will follow an ambitious timescale – unless there is further political intervention, the current deadline for transitioning to one of the new arrangements is 1st January 2028.

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Collective Defined Contribution pensions

A single definition of what Collective Defined Contribution (CDC) pensions are is difficult to come by as they can mean quite different things depending on the context. However, CDC pensions will usually have some overarching characteristics:

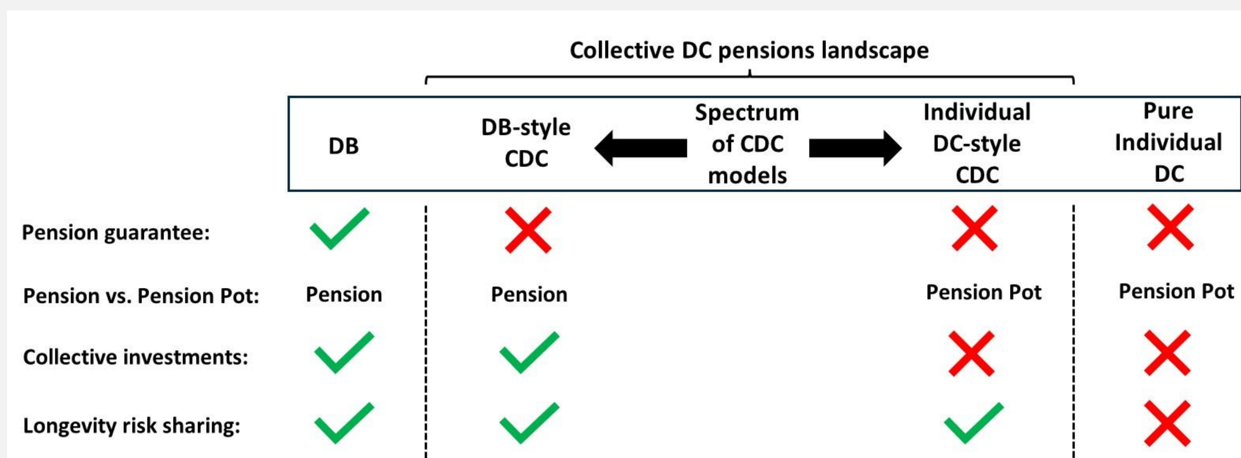
- **Some form of risk-pooling between members**
  - Generally, this might be a form of investment risk pooling, longevity risk pooling, or both
  - Risk pooling may cover the accumulation phase, the decumulation phase, or both
  - Insurance may also be used as an additional or integral part of the risk-sharing process
- **A lack of (formal) employer guarantee**
  - This is an important distinction with defined benefit. The lack of guarantee from an employer means that there must be a mechanism for benefits (be that in the form of accrued pension or pension capital) to be corrected for the realised returns and actuarial experience.

In the UK, CDC pensions are usually talked about in the context of the legislation which was recently introduced to allow them to be set up (the Pension Schemes Act 2021 and The Occupational Pension Schemes (Collective Money Purchase Schemes) Regulations 2022). This permitted companies to set up CDC pension schemes where members will accrue pension each year and receive a lifelong income after retirement (so accumulation and decumulation) and where investment risk and longevity risk are both shared.

In the Netherlands, most pensions are CDC – some are an evolved version of defined benefit (DB) pensions (where employer guarantees were removed). Also Dutch individual defined contribution pensions move into a form of CDC pension in retirement where there is a requirement to share longevity risk and provide an income for life.

Denmark and Canada are also countries which have implemented DB-style CDC schemes on a national, regional or local level. Canada and Australia also now have CDC at-retirement products available. In the US, although generally not mainstream, CDC solutions also exist in the form of variable DB, variable annuity, and hybrid solutions. All of these solutions have some form of risk-sharing involved.

Figure 1: The Collective DC pensions landscape



A brief history of Dutch pension provision

Dutch state pensions, the first pensions pillar, were introduced in 1957 and now provide around €17,500 (gross) per year to people living alone and around €11,900 per year to people with a partner[1].

Dutch occupational pensions, the second pillar, have a long and rich history. In the 1800s, pensions were established for rail workers and the first sector-wide pension funds began to emerge in the early 1900s. A key example was the ABP fund for civil servants in 1922 which is now the largest pension fund in Europe with assets of over €450 billion. Other large funds include ones for the care and health sector, for metal and technology industries, for the building industry, as well as many for individual companies. Together Dutch pension fund assets are now in excess of €1.4 trillion[2].

The third pillar of private pensions is relatively small given the high coverage of the second pillar. It is mainly used by the self-employed or by individuals who have residual fiscal allowance after their occupational accrual.

Current occupational pensions arrangements

A large majority of the occupational pensions described above were originally defined benefit (DB), comparable to UK defined benefit funds, with members accruing a given pension amount for each year of service. Pensions were normally calculated on the basis of final salaries but most have converted to a career average earnings model. This has similarities to the model many UK public sector-related pension schemes now use for accrual but, as we explain in more detail below, without the automatic indexing.

Most of these pension funds are now governed by the Financieel Toezichtskader or FTK framework (broadly translated as the financial assessment framework), introduced in 2015. This is a solvency framework where pension funds are required to maintain a given funding position. If they do not meet the funding position then benefits may only be partially indexed, or may not be increased at all. If the funding position is below a critical level for an extended period, benefits must be cut. For many years, there have been various tweaks to the solvency rules – for example, the discount rate methodology used to value liabilities has been changed at various points to become more in line with market rates (the current curve is now broadly in line with the swap market curve).

The largest pension funds are sector-wide but many large companies also offer “DB-style” CDC pension funds. Since 2015, General Pension Funds (“APFs” in Dutch) have been available. These allow pension funds to combine under one trustee board, either fully integrated with other pension funds or as separate sections of the larger pension fund.

Alongside these DB-style Collective Defined Contribution pension funds, there also exist individual DC pension arrangements, often referred to as “WVP”, the law under which they are regulated. These may be individual DC pension funds in their own right, DC sections of larger DB-style CDC pension funds, or multi-employer “PPI”s which can be broadly seen as a Dutch equivalent to UK DC Master Trusts. This represents a small but growing percentage of the total market. An important aspect of these pensions is that they must lead to a lifelong pension after retirement, in contrast to the UK where drawdown is available.

Why have the Dutch decided to reform their pension system?

One key reason is that the current system is seen by many as lacking transparency for members. After many years of strong asset returns, many members had expected pensions to increase but indexation was restricted due to the value of the liabilities also increasing. It was therefore felt that allowing individuals to see their own pension pot and the changes that made up the return on that pot would create greater transparency. As we will show, the new system also allows investment strategies to be tailored to each age cohort, rather than being a single investment strategy for all members.

Another reason is the change in labour mobility in the Dutch economy – just as in the UK, Dutch workers have become more likely to have several employers during their working life and having DB-style pensions accumulated with several different employers was not deemed to be practical and efficient. People who begin their career in salaried employment and later become self-employed are also disadvantaged by the current DB-style accrual which increases with age. Moving to a system

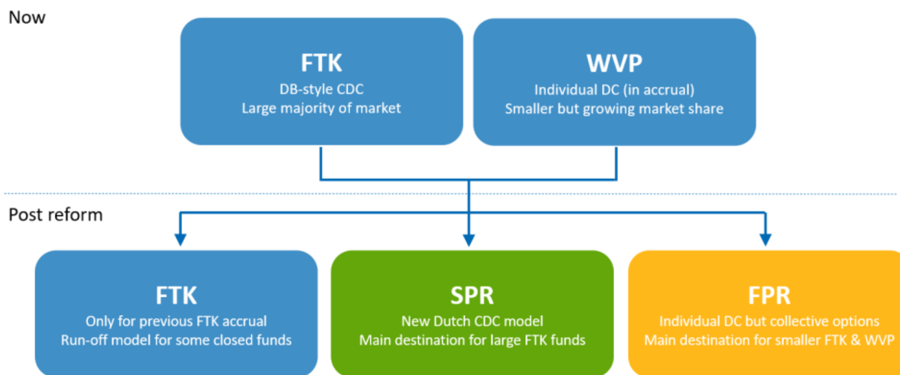
1 Levels applicable from 1 July 2023, Sociale Verzekeringsbank (SVB).
2 De Nederlandsche Bank as at 30 June 2023.

of individual pension pots and a single percentage contribution rate are therefore viewed as offering more flexibility and fairness.

Another important reason is the discussion of intergenerational fairness – a recurring theme from the Dutch pensions debate has been that discounting projected liabilities leads to questions of fairness, often in terms of whether younger generations are supporting the stability of older generations' pensions at the potential expense of their own future pensions.

An overview of the reforms

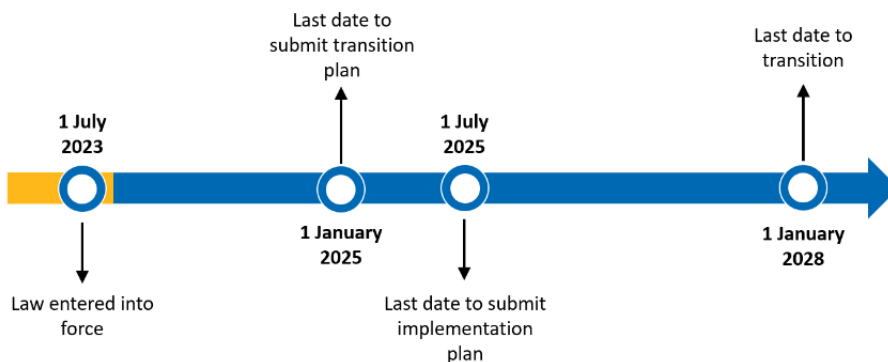
Figure 2: Overview of the Dutch pension reforms



Two new pension arrangements are introduced in the new pension law, the Solidary Pension Arrangement (SPR) and the Flexible Pension Arrangement (FPR). The SPR represents a new novel approach to Collective DC pension fund design, allowing pension funds to maintain collective investments but allocating the total capital and returns to individual member pension pots. The FPR maintains traditional individual DC pots before retirement but, at retirement, members' pension pots have to be converted to lifelong pensions, either via an insured annuity or a Dutch Variable Pension. We cover these two variants in the rest of this article.

Most large DB-style pension funds are likely to choose the SPR model, both for historic and future pension accrual. One important reason for this is that it allows them to maintain collective investments and so has less immediate impact on the way their investments are managed. Smaller DB-style pension funds may choose to continue with SPR but many may decide this is the moment to transfer to an individual DC-style arrangement under the FPR model. Most current WVP individual DC arrangements are likely to fall under FPR. For some pension funds, there is the option of leaving historic accrued pensions under the FTK regime and moving to one of the SPR or FPR for future accrual – this is likely to be a minority of funds though.

Figure 3: Current reform timelines

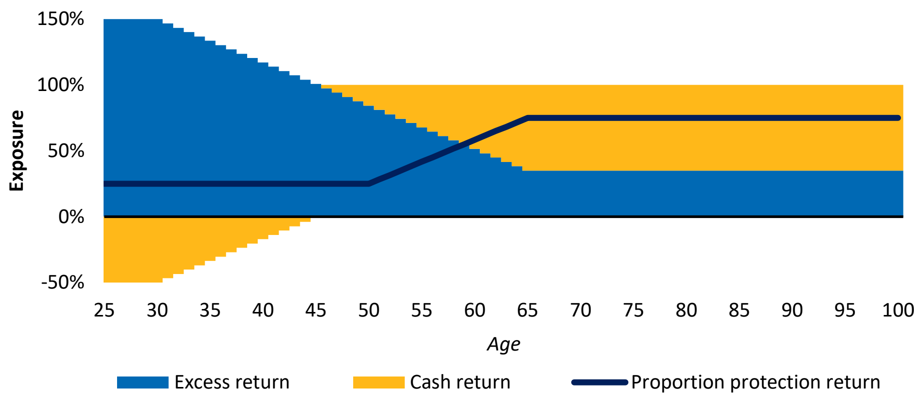


The timelines for implementing the reforms are tight. The law introduced on 1 July 2023 prescribes a deadline of 1 January 2028 for full implementation with deadlines in the intervening period for submitting transition and implementation plans. Most pension funds are already underway with planning and decision-making and will want to transition well before 2028.

The Solidary Pension Arrangement (SPR) – a novel CDC pension fund design

The SPR system combines a collective investment policy, with individual pension pots. The collective investment return is split into a protection return and an excess return and these are distributed to different age cohorts via exposures that are determined in advance. These exposures form a novel glidepath design:

Figure 4: SPR Glidepath example



'Protection returns' will be calculated for all members in the pension fund. One methodology to do this is via the change in value of the projected pension cashflows (of a deferred or immediate annuity) for a member over the given calculation period, representing a perfect interest rate hedge. The protection return for the member is then the return on the percentage of those cashflows which are hedged under the glidepath strategy (see black line in Figure 4) and a cash return for the unhedged cashflows, representing the time value of money.

Once protection returns for all the members have been allocated, the remaining aggregate collective return (be that positive or negative) then represents the total excess return. This excess return is allocated between different member age cohorts according to the excess return glidepath (the blue bars in Figure 4). Younger members who can take more risk (due to their future earnings and contributions) will receive a larger excess return weighting (up to a maximum of 150%[3]) whilst older members will receive a lower percentage to provide more stable pensions approaching and during retirement.

It is important that the collective investment strategy closely mirrors the aggregate interest rate hedging policy and excess return exposure per age cohort. If the glidepath creates issues at a collective investment strategy level, then this suggests the glidepath should be reconsidered as large discrepancies will feed through to unintended consequences for pension outcomes.

Alongside the individual member pots and glidepath strategy, there is a 'solidarity reserve'. This is designed to support age cohorts who are impacted by adverse market conditions. There are various rules about how it can be funded and with limits on how large it can become. Pension funds will need to form and maintain a policy for how the reserve is funded and when it should be distributed, e.g. to prevent or mitigate falls in pensions. Reserves are expected to be considerably lower than under the current FTK solvency framework.

Modelling carried out comparing SPR to the current FTK system suggests that, taking into account member risk preferences, it will lead to better risk-adjusted outcomes for members. This is largely due to the ability to tailor the investment strategy to each individual age cohort, rather than having a single investment strategy for all. This allows for more risk asset exposure at earlier ages and for interest rate risk to be applied at greater rates for older members where stability of pension is valued more greatly.

3 The maximum 150% comprises risk asset exposure. In the law, risk asset exposure comprises investments in non-fixed income (e.g. equities and property) plus part of the exposure to fixed income investments (dependent on their credit rating). The law specifies a mapping for assigning fixed income investments to risk asset exposure and credit risk-free exposure according to credit rating. The maximum of 150% is therefore likely to be to a diversified risk asset portfolio rather than only listed equities, for example.

The Flexible Pension Arrangement (FPR) – individual DC but with collective risk-sharing after retirement

In contrast to the SPR, the FPR is a more individual DC form of pension contract. Before retirement members will maintain their own individual pension pot, either invested according to a glidepath strategy or in self-select investments offered by the pension provider. Multiple glidepaths can be offered to cater for the different risk preferences of members, and providers will also be expected to determine, based upon member inputs, the most appropriate investment strategy for members. This is a key difference with the SPR where there will be only one glidepath strategy followed and no self-select options.

After retirement, members will have the option of a fixed or variable pension (see box below) and providers are obliged to offer an open-market option if they do not offer one of these two options. Within the legislation, there is also allowance for a risk-sharing reserve although this is not expected to be widely adopted.

UK versus NL CDC: some developing similarities but still significant differences

In the last section of this article, we look at some of the similarities and differences for the future of CDC in the Netherlands and the UK. A few of the changes which form part of the package of Dutch pension reforms package are immediately recognisable in the UK pension system:

A 10% commutation allowance at retirement – The option for members to take 10% of their pension value as a lump sum at retirement is included in the reforms and is currently expected to be introduced in 2025. This lump sum will however be taxed, unlike in the UK where tax-free lump sums can be paid.

A single pension contribution percentage, independent of age – up until now, Dutch pension contributions have increased with age. This is either implicit in DB-style CDC (where pension accrual is more valuable at later ages) or explicit in individual DC (where total contributions increase as a percentage of pensionable salary). Under SPR and for new members in FPR, this will change going forward as the pension reforms require pension providers to move towards a single pension contribution percentage. This is already the norm in the UK for DC.

For SPR, the reforms require that members who are disadvantaged by this change are compensated for it. This will largely impact members around the middle of their careers who have previously received lower effective contributions and will now not benefit from the higher expected contributions as they approach retirement. One source for this compensation may be from the reserves that many current FTK pension funds currently hold.

The introduction of CDC in the UK – this clearly also suggests comparisons with the Dutch pension system. Legislation has already been introduced for single employer CDC pension provision and further legislation is expected for multi-employer CDC and decumulation-only CDC although when this will be remains uncertain and subject to the political landscape. Where this differs from the Dutch reforms is that the existing UK legislation is based upon accruing pension rather than pension pots. Pensions will be reviewed at least annually and pension increases (or decreases in extreme circumstances) will be adjusted so that the value of the projected liabilities is equal to the value of the assets.

In capital terms, a change in pension increase for an older member is very different to a change for a younger member as that change in pension increase is expected to be applicable for many more years into the future for the younger member. The methodology therefore implicitly transfers capital value between different age cohorts according to the performance of the collective portfolio and changes in discount rates. However the extent to which this occurs will be determined by the age profile of the pension fund membership.

The Dutch SPR methodology, on the other hand, works with accrued pension pots (rather than accrued pensions) and makes the process for how returns are then distributed between members' pots very explicit and transparent. The collective investment portfolio should also be in line with the aggregate strategic exposure of the individual members', leading to a consistent strategy. One other key difference is that pension increases are not taken into account in the pension calculations and are therefore only payable if investment performance has been sufficient.

The manner in which the FPR has individual investments in the accumulation phase which can then convert to a Dutch Variable Pension at retirement also immediately brings to mind how the anticipated Decumulation-Only CDC model might work in the UK. The system of Dutch Variable Pensions therefore represents a good live international example which the UK could consider when looking at the possible methods of applying CDC in retirement.

Dutch Variable Pensions

Up until 2016, members with DC investments would generally convert their pots into insured fixed pensions or (where possible) use their DC investments to increase their DB-style pension in retirement. Dutch Variable Pensions were introduced in 2016 as an alternative option at retirement. The idea behind them is that they insure or pool longevity risk but there is continued investment (with the associated risk and reward) after retirement. Variable Pensions must be recalculated at least once a year, taking into account changes in members' capital values, changes in the interest rate curve, and any changes to longevity expectations, to determine an updated pension.

The law covering Variable Pensions allows for several choices in the set-up of solutions:

- Providers may offer several different investment strategies after retirement, allowing members to choose a risk profile to suit their risk preferences and circumstances;
- Changes to pensions may be smoothed over periods of up to 10 years;
- In projecting cashflows to calculate the pension payable each year, providers may allow for a reduction in cashflow each year. This implicitly allows for expected outperformance and thus a higher initial pension.

There are a couple of methods which may be adopted for smoothing pension changes. These are known as the 'Memoryless' and 'Roof tile' methods. Figure 5 shows an example of how the 'Roof tile' method works.

Figure 5: Example of 'roof tile' smoothing method

Example of pension smoothing over 3-year periods using the "roof tile" method

Changes in monthly pension with 3-year smoothing period	2022	2023	2024	2025	2026	2027	...	...	Total increase w/o smoothing
...							...	...	...
2027						€5.00	€5.00	€5.00	€15.00
2026					€10.00	€10.00	€10.00		€30.00
2025				(€4.00)	(€4.00)	(€4.00)			(€12.00)
2024			(€9.00)	(€9.00)	(€9.00)				(€27.00)
2023		€7.00	€7.00	€7.00					€21.00
2022	€5.00	€5.00	€5.00						€15.00
Total increase with smoothing	€5.00	€12.00	€3.00	(€6.00)	(€3.00)	€11.00	...	...	

The form of Variable Pension calculations also forms the basis for the way pensions will be calculated under the new pension contract. Here there are several questions which pension funds are currently considering. Two important ones are:

- How the solidarity reserve in the SPR arrangement will operate to prevent pension decreases;

And another is whether all retired members should receive the same pension increases – this makes communication much simpler but leads to questions about how pension capital values are administered to accommodate it. If members do not have 100% interest rate hedging in retirement or adopt different risk asset exposure with age during retirement, there need to be adjustments to the capital values members are holding for the same pension increases to be paid.

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