Retirement on a DC pension in NL and UK

Similarities, differences, and improvements

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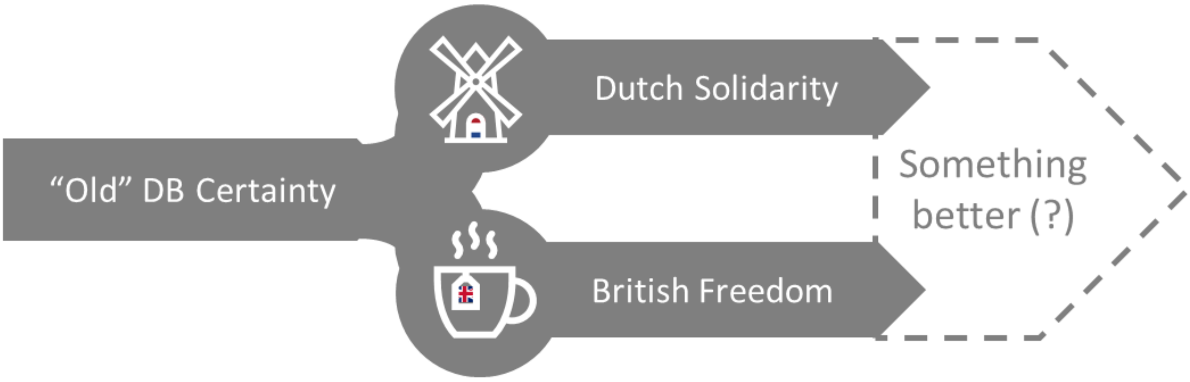
Introduction

Both the Dutch and the UK workplace pension system have been transitioning from Defined Benefit (DB) (or the Dutch Collective DC) pension schemes, towards a more Defined Contribution (DC) type of scheme. In these DC pension schemes; members will bear more of the risk in terms of managing their income in retirement. The way this transition is handled in both countries varies. The Dutch pension system attempts to mitigate some of the risk to members, using a 'solidarity' system, whereas the British pension system allows members the ability to be more flexible in their retirement choices, but they must make these decisions individually. Hence, the options at retirement, as well as the financial risk involved, are quite different.

This paper will compare the Dutch collective decumulation phase to the individual British decumulation phase in order to examine both the positives and the negatives of the two systems. Is one inherently better than the other or is a combination of the two more desirable?

This paper focusses on workplace pensions. Any state pensions or personal savings are out of scope.



The paper is constructed as follows:

- Chapter 1 discusses why many of us will retire on a DC pension
- Chapter 2 outlines the Dutch Retirement Options
- Chapter 3 outlines the UK Retirement Options
- Chapter 4 attempts to unify both systems into an improved approach through potential improvements that could be made to each pension system and summarizes the findings of the research project
- Appendix 1 includes a brief refresher of the pension systems in both countries

This paper is a cooperation between Hymans Robertson, a UK based consultant, and Sprenkels & Verschuren, a Dutch consultant. This paper focusses on the time after retirement (so called decumulation phase) and a "sister"-paper is available that discusses the differences, similarities and improvements in the period when employees save for their pension (the accumulation or pre-retirement phase).

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1 Why many of us will retire on a DC pension

Both in the UK and in The Netherlands, pensions are moving from DB to DC systems.

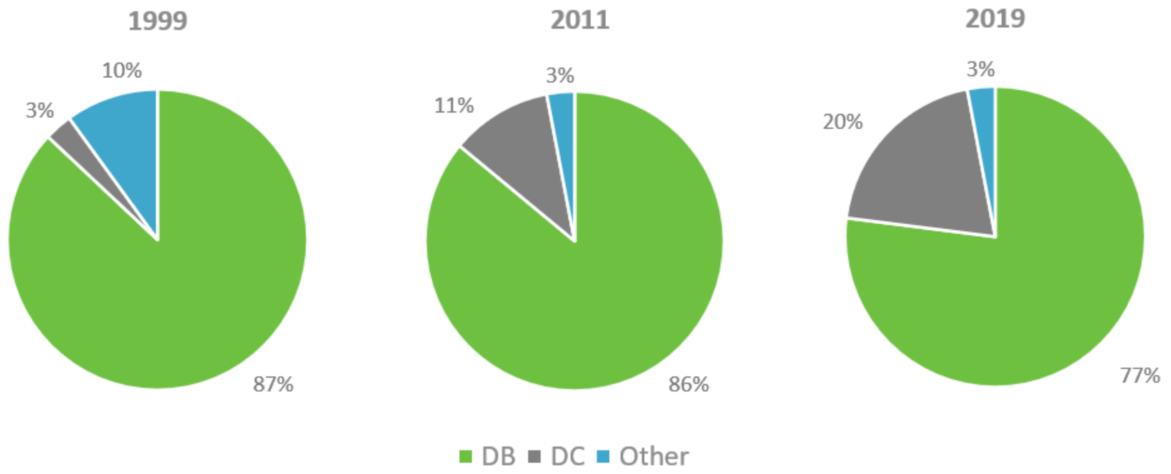
In a classic DB scheme, a member is paid a pension that is related to their salary and the length of time they were employed. The pension that members receive via a DB scheme is therefore not linked to the amount of contributions a member makes or the investment performance of the underlying funds. Instead, the pension a member receives is a ‘promised’ accrued right, based on their service and salary. Or in other words: the required pension outcome determines contributions and the investment policy.

Conversely, within a DC scheme the pension outcome a member receives is not calculated based on an accrued right, but instead typically driven by the level of contributions made in the pre-retirement phase, and their investment performance. Contributions and investment performance leads to an undefined outcome.

In a Dutch context, the pension outcomes of the DB scheme is dependent on the funding ratio. Currently, most pension schemes in The Netherlands are characterized as either a DB scheme or a so called collective defined benefit scheme. In both schemes, the accrued pension rights form the basis for premium/contribution and investment policies. In more recent years, however, there has been a decrease in DB and collective defined benefit schemes. This is due to the increased liability for employers, which has resulted in DC schemes gaining popularity. In the UK, the contributions required are also calculated based on expected future accrued rights.

In The Netherlands, factors that have contributed to making it difficult to maintain DB schemes for employers include persistent low interest rates, Dutch population ageing and the rising life expectancy. Thus, the financial position of most pension funds has been extremely poor since the Global Financial Crisis[1]. This, in turn, has affected the sentiment of Dutch citizens, causing the confidence of Dutch citizens in the pension system to subside. A new Dutch pension system for workplace pensions will be a DC based system. In order to make the transition from DB to DC the so called ‘invaren’ will transform DB rights into DC capital lumpsums. The legislation for the transition, as for the new pension system, is still in concept. In this paper, for the Dutch market, we will mainly focus on the DC side of the new Dutch pension system.

The charts below show the rise in DC schemes in The Netherlands as the percentage of Dutch employees in DC schemes has grown significantly over the years. The percentage for DB includes the collective defined benefit funds.



[1] We note that recently interest rates have seen a surge, resulting in an improvement of the financial position of pension funds in The Netherlands.

In the UK a trend in the move from DB schemes to DC has been visible for a longer period, for many of the same reasons outlined already, in particular driven by the high contribution requirements put on employers to fund the future accrued pension rights of members. The workplace savings market within the UK has transitioned significantly over the past 10 – 15 years, with DC now largely dominating the market and expected to continue to grow significantly compared to DB.

Therefore, the UK and Dutch market for workplace pensions are both seeing a similar trend towards DC pension schemes. In the remainder of this paper, we discuss how the approach to these DC pensions varies in both countries.

2 Dutch Retirement Options

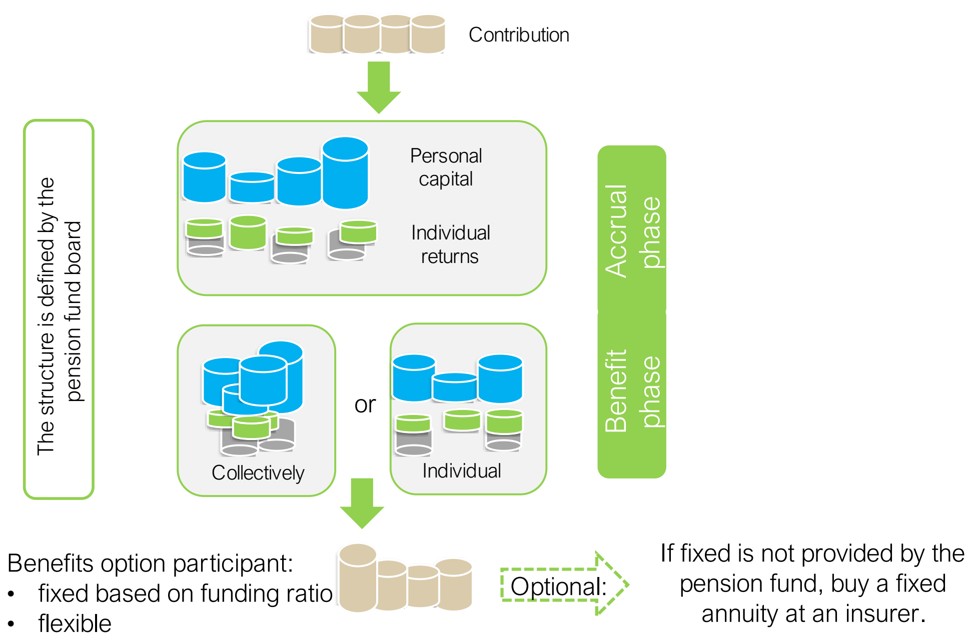
2.1 Dutch Solidarity

New legislation will transform the Dutch pension system. Although this legislation is not yet finalised for the new pension system, many pension funds are making preparations for the upcoming transition which is expected to start from 1 July 2023 with the latest transition date being 1 January 2027.

Under the new pension legislation, both a flexible DC arrangement as well as a solidarity DC arrangement will be possible. The solidarity contract is characterized by the collective accrual phase where investment risks are shared. The flexible contract is characterized by individual choices and the possibility for a collective decumulation phase. In this paper we will focus on the flexible DC arrangement.

In the flexible DC arrangement, it is possible for the pension fund board to choose between an individual or collective decumulation phase. In the decumulation phase the member has the option to choose between a fixed or flexible benefit. It is expected that most pension funds will not provide a fixed benefit, since insurers can provide a higher grade of certainty of the fixed benefit. This is due to the fact that within a pension fund, the fixed benefit is still somewhat dependent on the results (e.g., investment and longevity results) and not fully guaranteed. When the pension fund does not provide the option for a fixed benefit, the member has the right to take the capital and buy a fixed benefit at an insurer.

The figure below shows how the flexible DC arrangements can be structured in the new system.



When looking at the decumulation phase, in principle, both the collective and individual decumulation phase have some risk sharing.

The key difference between the collective and individual decumulation phase is that all benefits of the retirees can fluctuate from year to year in the collective arrangement. This is predominantly driven by the desire to manage or spread-out risk from shock economic events. Hence, there is a form of sharing investment risks in the collective decumulation, whereas in the individual decumulation phase there is not.

This is quite similar to the UK's annuity (see chapter 3). Still, in the collective decumulation phase every member has their own individual capital from which every year a certain amount of capital is withdrawn to finance the individual benefit. The member's remaining capital, however, remains in the collective pool. Note that the investment mix of individuals needs to be similar. Otherwise, imbalanced situations may occur. Hence there is more solidarity, but less flexibility.

2.2 Longevity risk

In both the collective and individual decumulation phase, it is mandatory by law to share longevity risk. Longevity risk can be split up between micro longevity risk (the chance that the individual is living longer than expected) and macro longevity risk (the chance that everyone in the collective is expected to be alive longer).

In the case of a premature death the individual capital remains in the collective capital (excluding the potential spouses' pension). This results in an increase of the pensions of the remaining members. In this manner, micro longevity risk is shared among the members.

Macro longevity risk can be shared by the collective via a buffer in some schemes. When the life expectancy of the collective is increased, the loss for the members will be partly compensated by the buffer (and the other way around in the case that the general life expectancy decreases).

When the pension fund does not provide the fixed annuity, members can choose to obtain a fixed annuity at an insurer. In this case the insurer takes on the individual's micro longevity risk, since the insurer provides a guaranteed lifelong annuity.

The advantage of sharing longevity risks is that the chance that the individual capital is inadequate for a member that lives longer than expected is mitigated. As there is no profit margin, within the pension fund the risk premium for this "flexible" annuity is less costly than the fixed annuity at an insurer.

2.3 Spread of investment results

In principle, the investment return in a year directly affects the pension benefit of next year. However, in the decumulation phase it is possible to spread the effect of the investment results up to 10 years in the pension benefit. The pension fund sets the duration of the spread for all members on the same number of years. For example: if the investment return is 10% and the spreading term is 5 years, the individual capital of the member increases by 10% but the next year benefits increase will be 2%. The implementation of the spreading term can be implemented in different ways, but in the end, this stabilizes the pension benefits year on year for the member. The spread can be done in the collective and individual decumulation phase. Whereas in the collective decumulation phase investment risks can be shared through spreading investment results across the full membership, in the individual decumulation phase this is not possible and only applies to the individual.

Note that introducing a long spreading period, however, introduces a risk. If the return of 10 years ago is still affecting the benefits of this year, communicating and explaining how the benefit in a certain year is defined will be very difficult. Also, when the results are persistently negative and is just partly incorporated in the yearly benefit, the individual capital of the members will decrease rapidly in the later years (snowball effect).

Typically, we see that for the stabilization of the pension benefits from year to year, a spread period of 3 to 5 years is sufficient.

2.4 Drawbacks of Dutch Solidarity

Sharing longevity risk and a spreading term for investment risk means that the Dutch system currently offers less room for individual freedom. Hence there is no way to (for instance) use a part of the pension capital to reduce one's mortgage, cover health expenses, etc. Also, for small pension capitals, some form of pension needs to be purchased. Often risk sharing means that a similar investment mix is required, which may also not fully coincide with the wishes of the member.

Further, there is a price on solidarity. The required buffer must be filled by either premiums or on positive investment returns. Due to the changing labour markets, employees tend to do more “job hopping”. When one leaves the pension fund and want to transfer their individual capital to another pension fund, they do not get part of the buffer or may need to ‘buy-in’.

Lastly, because of solidarity a pension never truly belongs to a Dutch retiree. After death, any remining capital will be for the benefit of the collective, not the individuals’ estate (excluding any potential spouses’ pension).

3 The UK Retirement options

The workplace savings market within the UK has transitioned significantly over the past 10 – 15 years, moving from DB schemes to DC schemes, with DC now largely dominating the market.

3.1 DB in retirement

Like in The Netherlands, in the UK, a DB scheme pays a member a pension that is related to their salary and the length of time they were employed. As discussed in the introduction, in the UK, contribution levels (predominantly paid by the employer) are calculated to ensure that the pension payment can be guaranteed for life. The amounts required can become very large if the scheme is poorly funded (perhaps due to investments performing badly, or the scheme expects members to live longer than initially expected and so require pension payments for a longer period). These factors have been the key drivers for the move away from DB pensions, as employers are unable to sustain the costs required to pay out these types of pensions.

3.2 DC in retirement

The concept of a DC scheme in the UK differs to that of a DB scheme. Members and employers both make regular contributions to an individual member's pot, which is individually invested up to (and beyond) the point of retirement. The employer costs (and risks) are reduced significantly in a DC scheme as the costs are limited to a contribution rate which the employer can set, subject to automatic enrolment regulations. If investments perform badly, the employer does not have to make 'top up' payments. Instead, the member bears the risk that the value of their pension savings performs badly, and their pension fund value is not large enough in retirement.

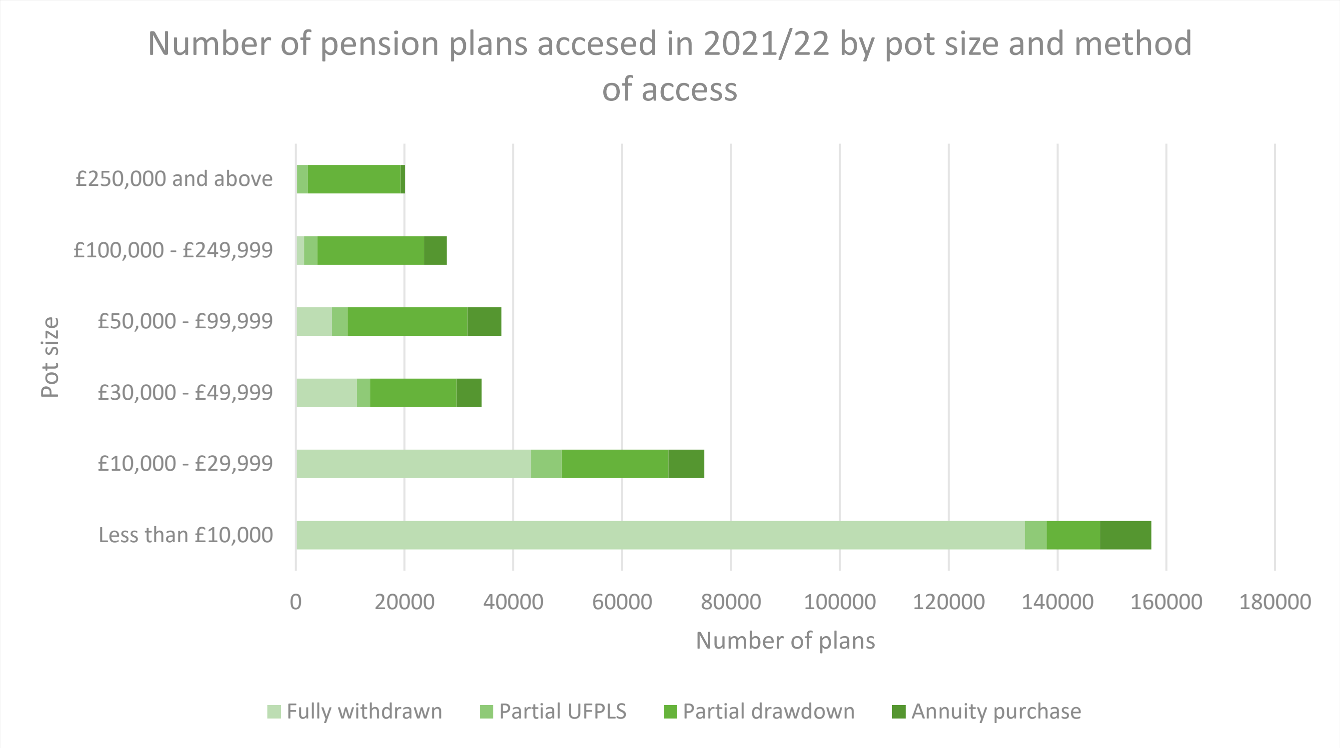
Further, in the UK, unlike in a DB scheme, the member is not automatically guaranteed a pension for life from their DC pension. In 2015, the UK saw the introduction of 'freedom and choice', which allowed greater flexibility with respect to how members can access their DC benefits when they reach retirement. Whilst there were some exceptions, the majority of members prior to this change had the option to take 25% of their pension savings tax-free and then were required to either purchase an annuity or enter into a capped drawdown product with the remainder of their pension savings. Since 2015 members are provided with more options as to how to take their DC pension benefits in retirement. These options include:

- **Purchase a lifetime or fixed term annuity** – take a one-off tax-free lump sum of 25% and use the remainder to purchase an annuity.
- **Use the pot to provide a flexible retirement income (pension drawdown)** – take a one-off tax-free lump sum of 25%, then use the remainder of the pot to provide regular taxable income.
- **Take a number of lump sums (UFPLS)** – 25% of each lump sum will be tax free.
- **Take the whole put in one go (Cash)** – 25% will be tax free and the remainder is taxable.
- **Keep the savings where they are and take them later.**

A combination of the above can be used to the members preference.

Following the introduction of freedom and choice, there has been an increased need to analyse trends at a member level to ascertain the most likely options that members are likely to take at retirement.

The chart on the following page outlines how members accessed their pension plans in the UK in 2021/2022 based on the overall size of the pension pot.



Source: FCA Retirement income market data 2021/22 - [Retirement income market data 2021/22 | FCA]

The key observations are:

- Annuity purchase remains the least popular choice at the point of retirement. This may potentially increase in popularity as pot sizes increase over time.
- Full cash withdrawal remains the most popular option for members with pot sizes below £30,000. This may reduce over time as the reliance on DB pensions reduces.
- For members with pot sizes above £30,000, some form of flexible or partial drawdown approach is the most popular option.

3.3 Issues of each pension freedom individually

Whilst the UK offers members with more options than the Dutch pension system would, which can be seen as a benefit to members, these options can present both advantages and disadvantages.

We also outline some of the issues that each option could present, alongside the benefits below.

- **Annuity** – A standard annuity can provide a member with an income for life (i.e. longevity protection), however, they lack flexibility. An underwritten lifetime annuity can provide a higher rate for people with lower life expectancies, but they are not available to everyone. A fixed-term annuity will pay out for a specified period, often with a lump sum paid at the end. However, they are not offered by all providers and does not provide longevity protection.
- **Drawdown & UFPLS** – These options can provide members with more flexibility to suit withdrawals at appropriate levels for their needs each year. However, a key issue is longevity risk. Savings can run out if investment returns are poor or if withdrawals are too high. Additionally, given the member makes the investment decision, there is some element of investment expertise required.

- **Cash** – Cash can suit members who may have additional savings (e.g., DB) elsewhere to provide, enabling members to use the DC cash to pay off shorter term needs. However, this option is unlikely to keep up with inflation. There are also tax implications with taking larger pots all as cash in one go.

Despite the potential issues that could arise with each of the pension freedoms individually, it should be noted that the appropriateness of each of these will be driven by individual retirement needs and some pension freedoms will provide a better fit than others.

In general, a key issue with the UK DC market at retirement is that members often make a non-advised choice as to what option (or combination of options) is best for their situation. This can lead to making a sub optimal decision. Education is needed to support members to make the right choices.

3.4 How is the UK addressing some of the investment risk in decumulation?

Currently, in the UK, the most common method for taking benefits in retirement is gradually pivoting towards income drawdown. Recently we have witnessed the majority of pension providers moving to offer members the ability to drawdown from their pension pot within the same scheme - previously this wasn't always available in scheme.

As discussed, income drawdown provides members with flexible access to their pension savings and, unlike The Netherlands, enables members to pass on their savings to loved ones in the event of an early death.

However, in drawdown, this investment, much like the accumulation phase, is individual. Therefore, a key disadvantage of drawdown is longevity risk and knowing how much is needed in retirement and when this might be needed throughout retirement. This poses a challenge to members who have to decide how to invest their money to suit their retirement plans. For this reason, the FCA (a UK regulator) introduced the 'investment pathways'.

The idea of the FCA Investment pathways is that members entering drawdown have a choice of options which support them in ensuring their drawdown pot is invested appropriately:

Option 1: Don't touch it
"I have no plans to touch my money in the next 5 years"

Option 2: Annuity
"I plan to use my money to set up a guaranteed income (annuity) within the next 5 years"

Option 3: Drawdown
"I plan to start taking my money as a long-term income within the next 5 years"

Option 4: Spend it all
"I plan to take out all my money within the next 5 years"

A benefit of the above pathways is that they help ensure that members entering drawdown are invested in cash only if they take an active decision to do so.

Whilst this will lead to improvements in the suitability of where a member's money is invested in retirement, the issue of longevity risk continues to persist, and changes in circumstances over time will likely mean that a members pathway choice could at some point become inappropriate and unaligned with their revised retirement plans as personal circumstances and health changes through retirement.

4 Conclusion: Improvements in both pension systems

Both the Dutch system and the UK system have their benefits and drawbacks. The table below compares the options available to members in the Dutch and the UK decumulation phase.

	Dutch Solidarity	UK DC
Current retirement options (choice)		
Fixed annuity	Yes (possible at an insurer)	Yes
Flexible annuity	Yes	No
Drawdown	No	Yes
Cash	Up to 10% of one's capital (taxable).	Up to 25% of one's capital (tax-free).
Flexible investment mix	Limited	Yes
Collective risk sharing	Range of options from longevity to investment risks	Limited

As discussed, in the Dutch system there is collective risk sharing in the decumulation phase, whereas in the UK, collective risk sharing is much less common within the options available, leaving members vulnerable to some level of investment and or longevity risk.

4.1 Pooling in the UK context

The UK pension market has recently seen the introduction of "UK CDC", potentially offering a middle ground between DC and DB, as members will have greater certainty around retirement incomes (than with DC) and greater certainty around costs and contributions (than with DB).

Contributions are pooled across the scheme membership and are invested collectively, providing access to a wider range of assets that can't be accessed from a typical individual DC pot. Employee and Employer contribution levels are fixed and are not subject to change, whilst member benefits are provided in the form of an annual income, which can rise or fall relative to inflationary and investment changes. In the retirement phase, this is quite similar to the new Dutch system.

Advantages of CDC relative to UK DC

- No member involvement in investment or investment decisions removes the requirement for member technical knowledge.
- Collective investing allows access to a wider range of return seeking assets, including illiquid investments. Additionally, this collective investment allows for volatility smoothing so that member pension levels are relatively stable.
- Member retirement benefits are expressed as an annual income as opposed to a pension pot, as well as outcomes being more predictable, allowing for easier communication and retirement planning.
- Members don't endure the longevity risk of running out of money in retirement as they would from pension drawdown.

- Contribution costs are fixed, providing cost certainty to the Employer.

Challenges of CDC relative to UK DC

- Members have exposure to potential benefit cuts even whilst in payment, adding an unexpected nature to their annual retirement income.
- Higher potential risk exposure and cost for Employer and requirement for a Trustee.
- Less flexibility for a member to use their benefits than they have with DC pension freedoms.
- Potential unfairness in the smoothing of investment returns.
- Questions around the absence of underwriting involved and whether this creates unfairness across the benefits that are calculated for members of different circumstances.

With the introduction of UK CDC being very new, there is still a lot of debate around the ways in which it should be utilised. Many view it should be used as a post-retirement option only, whilst the only existing CDC scheme in the UK currently is being utilised for both the accumulation and decumulation phase.

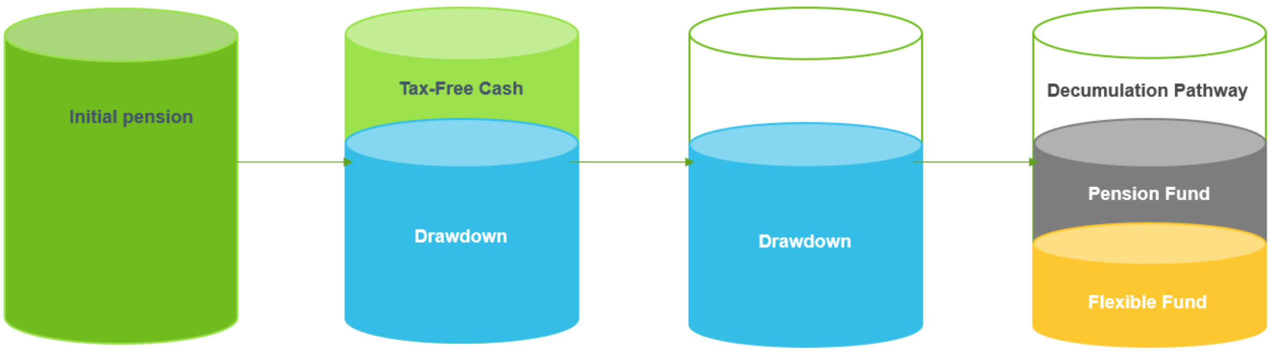
CDC presents an option to improve the security to members benefits in retirement through the pooling of risks.

Splitting the DC pot

The key issues (costs in respect of annuity) and risks (longevity and investment in respect of drawdown) noted when utilised individually, could be tackled by taking advantage of a combination of these two options or making use of an additional product which offers some pooling of risks (such as CDC) or similar alongside them in decumulation. The Dutch pension system is further ahead in terms of pooling of risks for members and the UK can learn from this.

Recently, the Institute and Faculty of Actuaries (IFoA) Pension Decumulation Pathways Working Party have discussed proposals* which aim to split the drawdown DC pot into two components through the introduction of a 'decumulation pathway' ("DP"):

- 'Pension fund' – Employed to generate a lifetime income.
- 'Flexible fund' – to allow members to maintain flexible access to their retirement savings.



* [Two-part solution: decumulation pathways | The Actuary]

'Pension Fund'

Given this component needs to meet the criteria of a lifetime income, there are a few obvious products which could be used, in particular, some form of annuity.

Due to the large cost drawback of the lifetime annuity within the UK and the 'guaranteed' element restricting the level of investment freedom, market proposals are considering a CDC vehicle to be used for this component.

Alternative proposals also consider the use of other pooled pension products, such as the Dutch model which we've referred to. A product of this form would allow for longevity risk to be pooled between members.

'Flexible Fund'

The flexible fund component is intended to follow the same process as the current UK DC market in retirement, allowing members to flexibly access their pot via flexible drawdown. Allowing members to flexibly access their individual DC pots in some form gives a fairer element to accessing retirement benefits, as DC pots aren't forfeited or do not remain within a 'pooled' fund upon death. They instead are transferred to the members estate, to be distributed to the relevant beneficiaries.

What needs to be considered?

Making a pooling product available to members in retirement will provide members in the UK with an option to invest some (or all) of their pension savings in a product that provides protection against some of the risks already discussed (namely longevity or investment). Introducing this as an option to sit alongside un-pooled solutions would allow members to continue to access some the flexibilities introduced by Freedom and Choice. We think this could present an optimal range of options to members in retirement.

However, in doing so, some key considerations as to how to implement and how this would work in practice should be considered:

- **What proportion of pension pot should be attributed to each option?** The majority of DC members do not have the underlying knowledge to decide how and when to withdraw their benefits, which begs the question. For example, in relation to the IFoA's proposal above, in which proportion should the 'pension' and 'flexible' fund be applied, and whether this should be a member decision or an agreed decision by the Trustee Board.
- **Investment strategy** – the DC accumulation phase would need to be considered. The accumulation phase would have to consider the proportion of pensions that members would be expected to invest in each option when at retirement. If pooling is introduced and members do want to have some of their pension in a pooled fund at retirement, the accumulation phase would need to consider an element of phasing into a pooled pot and designing a suitable asset mix for this pooled 'Pension Fund' both prior to and in retirement.
- **Phasing from an individual to a pooled pot** – Linking largely to investment strategy, an important consideration will be how assets are transitioned from an individual pot to a pooled 'Pension Fund' and how frequently this should occur.

4.2 More freedom of choice in The Netherlands

One of the key differences between The Netherlands and the UK is that currently a large number of the British retirees receive a fixed annuity from old DB schemes. This allows for more flexible and risky pension choices regarding the DC scheme. This is likely to change in time as more members retire without a DB pension to sit alongside their DC pension.

In The Netherlands most retirees receive a semi-fixed annuity from a DB scheme. The difference, however, is that in the new pension system, all DB schemes get transferred to a DC scheme. Thus, in the new pension system, there is less room for risky flexible pension choices, as there is only the state pension to fall back on. Because of this, a drawdown system, or an unlimited cash out option (partly taxable and partly tax-free) would not be desirable in the new Dutch pension system.

Having said this, in the new pension system there will be flexible choices. Similar to the 25% cash option in the United Kingdom, in the Dutch new pension system there will be a 10% cash option. The difference however being that in the United Kingdom the cash option is tax-free and in The Netherlands it will be taxable. In determining whether more flexible choices are desirable, one should consider not only the increase in welfare due to a more tailored pension scheme, but also the risks it accompanies.

In The Netherlands, by law there is a certain degree of obligation to inform your members about the choices they have. The more choices they have, the more difficult it will be to enable your members to make the right choices. The administration and communication will need to be improved. Also, the timing of the choices will be more important. However, an extra degree of choice (for instance increasing the lumpsum possibility to more than 10%) or a partial drawdown, may benefit the Dutch system. Especially for certain industry wide pension funds, the options for a partial drawdown system might fit the needs of the participants well. Here, the concept as mentioned in the section 4.1.3 of splitting the DC pot in the decumulation phase is very interesting. This might be introduced in The Netherlands as well. Where you could even split the pension capital into a collective (with risk sharing) and individual (flexible individual choices) system.

Naturally, this brings up the question how to invest in the pre-retirement phase depending on the numerous flexible choices. This will be outlined in detail in our follow up paper which considers the different risks in the construction of the glidepath in the pre-retirement phase.

Appendix I: UK and Dutch DC systems at a glance

The Dutch system

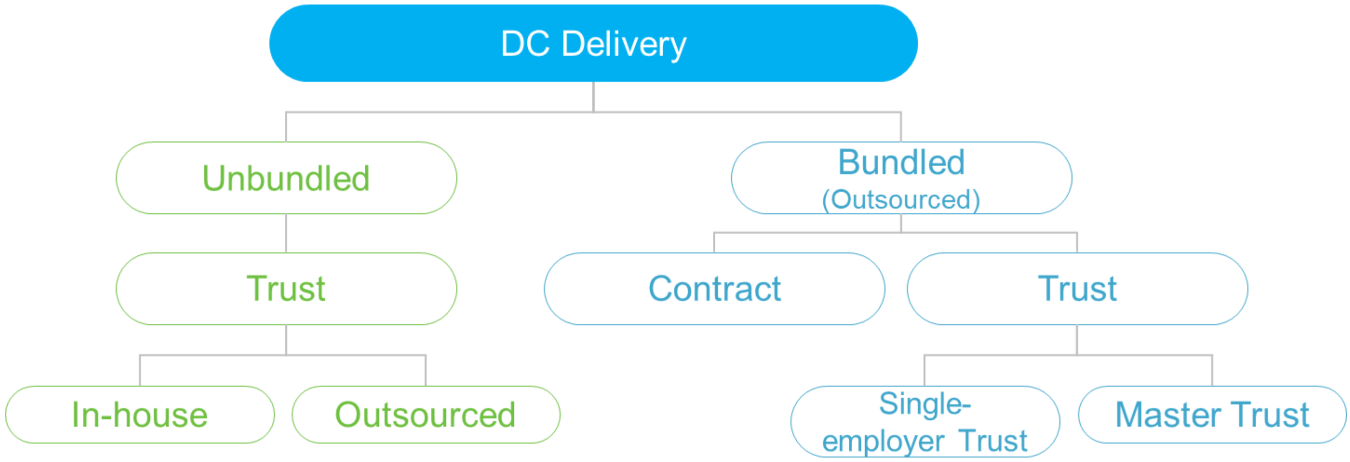
In 2020, the Dutch government has announced pension reforms. The goal of the new pension system is to create a sustainable pension system that: accelerates prospects for a pension with purchasing power, makes pensions more transparent and personal and is more in line with developments in the society and the labour market. In the last year, however, the new pension system was concretized, and implementation is expected in 2023. In no later than 2027 all future pension accrual is discontinued in the current pension system and has to take place in the new pension system.

The new pension system is comprised of two DC-like contracts: a solidary and a flexible contract. The solidary contract is characterized by the collective accrual phase where investment risks are shared. The flexible contract is characterized by individual choices and the possibility for a collective decumulation phase. Since this paper is heavily focused on a collective decumulation phase, we will consider the flexible plan in our discussion.

The UK system

The workplace savings market within the UK has transitioned significantly over the past 10 – 15 years, moving from Defined Benefit (DB) schemes to Defined Contribution (DC) schemes, with DC now largely dominating the market.

The workplace DC market consists of multiple different vehicles for delivery of pension schemes, all of which have been adopted by employers to some extent.



Predominantly and historically, employers operated their workplace schemes via a Single-Employer Trust Vehicle, maintaining a separate Trustee Board for oversight of the schemes. We have gradually begun to see a gain in momentum in the use of the Master Trust delivery vehicle, with a movement away from Single-Employer Trust schemes.

Following the completion of auto-enrolment staging, most UK employers now operate a pension plan for their employees. Master Trust providers were particularly successful during the auto-enrolment staging process, growing from minimal levels of assets under management in 2012 to over £100bn in 2022, and Hymans Robertson expect this growth trend to continue.