Nationaløkonomisk Tidsskrift 150 (2012): 228-233

Benchmarking the Danish pension system: a comparison with Dutch pensions

Lans Bovenberg
mail: a.l.bovenberg@tilburguniversity.edu

The Netherlands and Denmark are look-alikes in many respects. Our flat countries are so similar that some foreigners cannot distinguish between them. When I lived in the U.S. and told people that I was from Holland, Americans often responded enthusiastically: »Yes, I have been there: I visited Copenhagen.«

Of course, we know better. Both of our nations are unique. We realize this most when our national teams battle on the soccer field. Two years ago the Dutch beat the Danes during the World Championships in South Africa: 2-0. Our first win on the way to the final: what a wonderful tournament that was! But this year you guys took revenge at the European championship and beat us: 1-0.

Let's change the subject before this all gets out of hand: Pensions! But things are not much better there. Also here Denmark beat the Netherlands. In the final of the world championship pensions organized by Mercer – we have just heard about it – the battle between Denmark and the Netherlands ended in resounding victory for the Danes. Participating for the first time in this tournament, the Danes took the gold away from the Dutch.

Common scores

But before we go for the battle, let's start on the common ground. Indeed, Denmark and the Netherlands both score a number of major points.

Capital funding

A first score is that they both feature well-diversified pension systems with not only a well-designed PAYG financed public pension pillar aimed at poverty alleviation but also a large funded component aimed at maintaining the standard of living of the workforce during retirement. Funded pension systems do not have such a good name anymore after the recent financial crisis. Funded systems relying on financial markets would be unsafe.

For two reasons, however, funded systems have become more rather than less desirable after the crisis. First, funded systems allow citizens to better diversify risk. Pay-

Lans Bovenberg is a professor of economics at Tilburg University and founder of the Network of Studies on Aging, Pensions and Retirement (Netspar).

as-you-go pensions leave citizens heavily exposed to the credit risk of their own governments. Indeed, to ensure the sustainability of public finances, pay-as-you-go pensions are under pressure in several countries. European pension systems become safer if pension promises are backed by diversified financial instruments rather than by a claim on a single government only. Indeed, funded pensions contribute to a deeper, more integrated European capital market that allows for more international risk sharing. In fact, funding pensions is part of building a more integrated Europe, which is especially important for small countries like Denmark and the Netherlands.

The second argument for funding pensions is that this helps stabilize Europe's financial system without hurting the growth potential of the economy. Europe is an overbanked continent that relies too heavily on short-term money for financing long-run investments. After the financial crisis, regulators and capital markets rightly became nervous about the mismatch and liquidity risks on the balance sheets of banks. As the costs of bank finance rise, long-term pension savings become a more important source for financing long-term investments, innovation and growth. Indeed, pension funds have a more secure funding basis because savings cannot be withdrawn on short notice. They therefore can adopt long-term investment strategies.

Collective occupational schemes

A second related score for both countries is that they feature collective, occupational pension systems based on collective bargaining between employers and trade unions. Pensions are complicated 'trust' products. Financial illiteracy gives rise to serious agency issues, as households have to delegate these complex decisions to professionals and financial institutions. The involvement of employers and unions raises the confidence of the workers that the schemes are run in their interests. Moreover, collective pools created through the employment platform raise the buying power of workers, reduce distribution costs and alleviate selection in insurance. Mandatory old-age insurance also addresses various behavioral issues and combats moral hazard associated with means-tested public retirement benefits aimed at alleviating old-age poverty. Indeed, individuals will not voluntarily save if they know that the government takes care of them in retirement.

Danish scores

We now go to the scores for Denmark.

Stand-alone funds

The first score for Denmark is that 25 years ago it started out with a defined-contribution system right away. Hence, it does not carry the legacy of company defined-benefit systems in which firms bear the financial risks. This business model of companies acting as insurer is no longer sustainable. Indeed, many countries are moving away from it – including the Netherlands. Denmark does not face the associated transitional problems because it based its pension system from the very start on specialized, stand-alone pension institutions that rely on financial assets rather than sponsoring companies to back their promises. Hence, unlike in company defined-benefit plans, participants are not exposed to the credit risk of the firm in which they work for. The Danes also set a fixed contribution rate, which does not vary with the financial situation of the pension funds. The Dutch are now going through a painful transition from defined-benefit pensions to what the Dutch call defined-ambition pensions. In these pensions, contribution rates are capped and participants bear the financial and demographic risks of occupational pension funds.

Solvency 2 proof regulation

The second score for Denmark is that you made your pension system consistent with solvency 2 regulations. When pension providers promise nominal pension guarantees, Denmark is much more serious than the Netherlands in forcing these providers to hedge their risks. As a direct consequence, Danish pension providers are more experienced in hedging nominal pensions than their Dutch counterparts. Pension regulations in Denmark make a clear distinction between nominal guarantees, on the one hand, and risky pensions based on life-cycle investment strategies, on the other. The Dutch, in contrast, have a single, much more hybrid framework for regulating pensions. In particular, the valuation of nominal pension rights is based on the fiction of nominal guarantees and thus is based on the nominal risk-free term structure. However, the regulator does not force pension funds to match these obligations at low funding rates so that pension participants run the risk that their pension benefits are cut in nominal terms. In fact, many Dutch pension funds probably have to cut pensions in payment next year – some large funds may have to cut their pensions by as much as 7 percent.

Transparent individual property rights

The third score involves the definition of transparent individual property rights and, related to that, the individual link between contributions paid and new accumulated pension rights. The Danish pension system is based on nominal guarantees and, in the case of life-cycle investment, individual investment accounts. The Danish pension system takes great pain to avoid redistributing contributions across generations. The Dutch, in contrast, come from a long tradition in which intergenerational solidarity is a key concept. The rhetoric of intergenerational solidarity has led to a rather opaque pension system in which the trustees of pension funds can redistribute considerable sums of money from one generation to another. This intransparent system raises serious governance issues and increasingly results in intergenerational conflicts. In fact, it is increasingly criticized, especially by younger workers who no longer automatically trust the trustees. A major challenge for the Dutch pension system is to define individual property rights better and to ensure that contributions made on behalf of each individual in fact accrue to that same worker. A related advantage of the Danish system compared to the Dutch one is that the better defined individual property rights in Denmark provides more scope for tailor-made risk management aimed at the needs of particular groups and allow even for individual choice in risk exposures.

Financing the housing market

The fourth score for the Danes involves the housing market. Danish pension funds play a key role in financing the Danish housing market. In fact, about a third of the assets of Danish pension funds and insurance companies are invested in Danish mortgage bonds. In this way, the Danish pension sector plays a crucial role in the Danish society that goes beyond the provision of retirement income. The regulator has stimulated domestic investment of Danish insurance companies by basing the discount curve in part on the returns on Danish mortgage bonds. Whereas 60% of Danish pension money is invested in Denmark, in The Netherlands almost 90% of Dutch pension saving goes abroad. Hence, Dutch banks must finance their large mortgage portfolio elsewhere in the world. In the face of the euro crisis and in the aftermath of the credit crisis, this now yields serious macro-economic problems for the Dutch economy in general and the housing market in particular.

Supporting the public finances

The Danish pension and insurance sector provides another major contribution to the Danish society. And this is the fifth – and final score – of the Danes. The Danish government levies a 15.3% tax on the returns of pension savings. The implicit tax on Danish pension saving is even larger in view of the means-tested pay-as-you-go pension system in Denmark. Occupational pension savings thus contribute significantly to the public finances, both through tax revenues and lower means-tested pension payments. In the Netherlands, in contrast, returns on occupation pensions are not taxed, publicly financed pay-as-you-go pensions are not means-tested and mortgage interest payments are deductable at high marginal rates. This associated tax arbitrage results in large pension savings but also a lot of mortgage debt. The Dutch are increasingly concerned about the associated tax arbitrage. This is a real threat to the Dutch occupational pension sector. Indeed, an increasing part of the population is skeptical about the benefits of large retirement savings.

Dutch scores

The Danes have got enough credit now. It is time to talk about the Dutch scores.

Advanced risk management

The first Dutch score involves risk management. The Danes focus traditionally on providing nominal guarantees and hedging nominal interest-rate risk. Dutch pension funds, in contrast, focus more on the ambition to let pensions rise with wage inflation during the accumulation phase so as to yield a stable replacement rate at retirement. During the pay-out phase, Dutch pension funds aim at having pensions increase with price inflation so as to protect the purchasing power of retirees.

The Danish pension sector should focus more on inflation risk in the years to come. This should stimulate the development of inflation-linked financial instruments, for example in the housing market or through index-linked bonds issued by the government. More generally, the government may help the pension sector by issuing new financial instruments, such as longevity bonds and wage-indexed or consumption-linked bonds.

Dutch pension funds not only feature a different hedge portfolio than their Danish counterparts, they also exhibit a larger speculative portfolio because of a different attitude to risk. Whereas the Danish pension industry focuses on guarantees, the Dutch pension world focuses on taking and sharing risk – especially if long time horizons are concerned. Guaranteeing pensions over periods longer than 10-15 years does not make sense. The world is simply too uncertain. The only guarantee we can give over such a long time period is that we share macro-economic risks fairly and efficiently. And here I take the Dutch view. Especially during the accumulation phase, the investment perspective rather than the insurance perspective should be the dominant perspective in pension finance. Rather than guaranteeing pensions by hedging all risks on financial markets, pension funds should exploit risk premia and allow for mismatch risk with its income goals. This also raises the question how (fast) pensions in payments should vary with financial risk.

Low interest rates make guarantees increasingly expensive. For this reason, also in Denmark the investment perspective is gaining currency: life-cycle investment is becoming more popular. Here, Denmark can learn from the Dutch asset-liability framework. Indeed, liability-driven investment remains important even though liabilities are no longer guaranteed. In particular, investments should be set on the basis of the income goals for retirement and acceptable risk bands around these income ambitions.

Annuitization and lack of means testing public pillar

The second – and unfortunately last – Dutch score in this pension game involves the lack of means testing in the public retirement pillar. This makes saving for retirement and annuitizing these savings more attractive. Indeed, paying out occupation retirement saving through lifelong payments is compulsory in the Netherlands. The Dutch have also thought more about how pensions in payments can be risk taking and should be adjusted after financial shocks. Fortunately, the Danes have moved more towards annuitization but must take additional steps. The lack of means testing in the Netherlands contributes importantly to the legitimacy of significant compulsory occupational saving that must be annuitized. It also contributes to people voluntarily saving for retirement.

Conclusions: Netherlands-Denmark 2-5

I convey the Dutch congratulations from the Dutch for the 25-year anniversary of the Danish occupational pension system. Note that the game ended in 2-5, i.e. 25! We also congratulate you with the world championship organized by Mercer. But be warned. To become world champion is one thing, but to maintain that title is much harder. We want that gold medal back!

Our countries face common challenges in the years to come. One major one is to communicate purchasing power risks to individual participants and to help individuals deal with that risk. Another challenge is the governance and transparency of mandatory pension systems, including reporting of costs on a comprehensive basis. Maintaining the legitimacy of mandatory systems in increasingly individualized societies is a major challenge indeed. A final one is developing, maintaining and using human capital up to a higher age, as low interest rates and raising longevity demand higher effective retirement ages.

We are looking forward to working closely with you in bringing the gospel of funded occupational pensions to the world – using financial markets for social goals. Our two countries are the living proof that it can be done. Let's together continue our good fight, first of all, for the good of our own citizens and the stability of our own societies but also for the good of Europe and even the world. Let's face it: the Danes and the Dutch are on the forefront of pension innovation. So let's celebrate today and then tomorrow go back to work to take up our responsibilities for our citizens, for our countries, for Europe and the world.