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Future pensions act: budget neutral, benefit neutral or a compromise?

In the new pension system, all newly introduced pension plans will have an age-independent contribution. This is a change compared to the current system that is based on an age-dependent premiums. This change has different consequences for employees of different ages. Younger employees, for example, generally receive less contributions whilst older employees receive more contributions in terms of premiums. As a result, a compensation issue may arise in which the amount and method of possible compensation will differ per situation. The transition will start with the expected legislation in the beginning of 2023 with a transition period until 2027. If, in the near future, an acquisition takes place, it is wise to provide an early insight into the possible impact on future costs, both current and one-off, and on the compensation package as a whole. In this article we will discuss the financial impact of three possible scenarios.

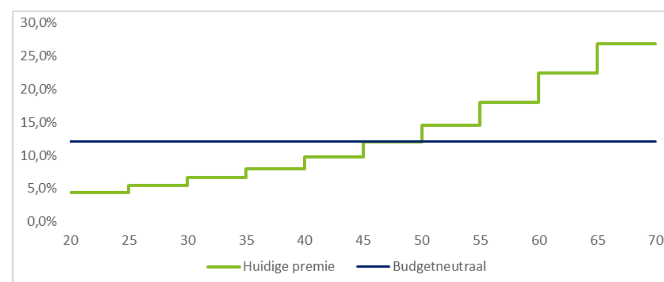
NB: In this article we do not take transitional arrangements in consideration. Would you prefer to gain more insight into the transitional arrangements? Please consider the following article.

Example employer

The example employer has 50 employees, uniformly distributed between the age of 20 and 68 years old. For simplicity we assume all employees have an annual salary of € 50.000, work on a full-time basis, will not be receiving any raises and will be working for the employer until their retirement at the age of 68. The current premium rates runs from c. 4% of the pensionable base for employees between the age of 20 and 25 years old, until c. 27% of the pensionable base for employees above the age of 65 years old ('100% of the age-dependent premium cohorts based on an interest rate of 4%'). In example calculations solely the impact of the pension contribution is presented, without any raises or additional costs.

Scenario i: Budget neutral

The base-case scenario for the switch from a premium based on age to a flat-rate contribution is a budget neutral transition. In an example calculation we present how this affects the premiums in the first five years. The current premium based on this employee file adds op to c. € 189.000 in 2023. A budget neutral transition to an age-independent premium for the current population would result in a horizontal premium of 12.1%.



However, this flat premium of 12.1% will only be budget neutral in 2023. In 2024, the premium in the current pension plan would increase, because some employees would end up in a higher age cohort. The figure below illustrates this: With both the current and new plan, the premium decreases due to the retirement of one employee per year. However, in the current pension scheme, the annual contribution per employee is increasing, which virtually reverses this decrease.

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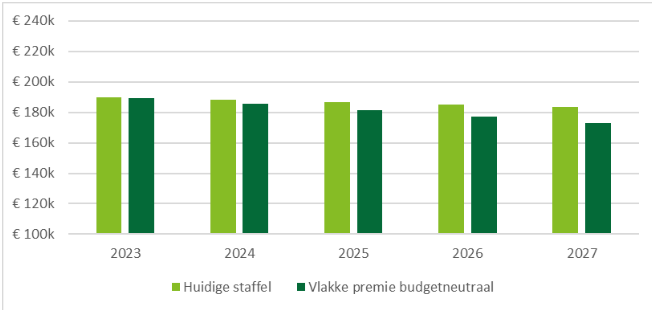
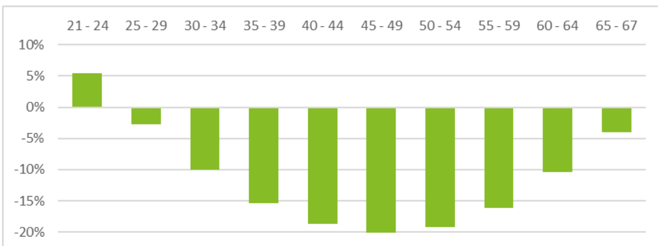
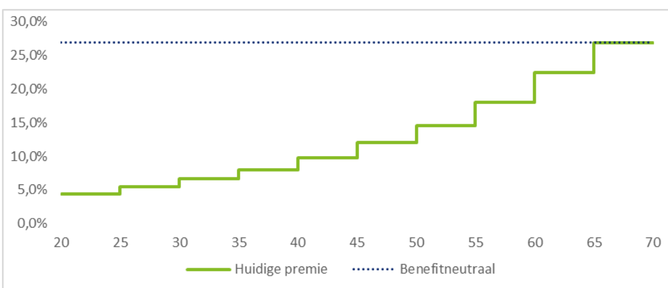


The figure below shows the difference in relative future pension capital built up in the new pension plan compared to the current pension plan, per age cohort. For example: a percentage of 10% implies that the expected accrual of future pension capital in the new pension plan is 10% higher than in the current pension plan. In the calculation, we assume a return of 1.5% on the contributed premiums. This clearly shows a decline in pension capital for almost all age cohorts. As a result, employees in these age cohorts may expect compensation, should a budget neutral transition take place.

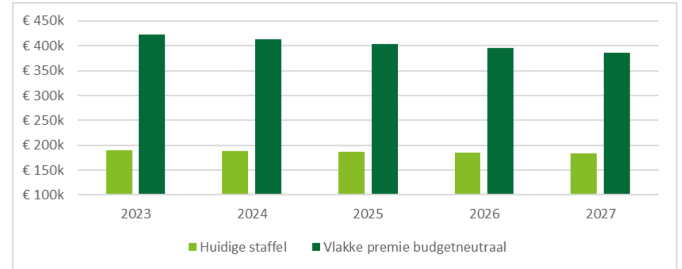


Scenario ii: Benefit neutral

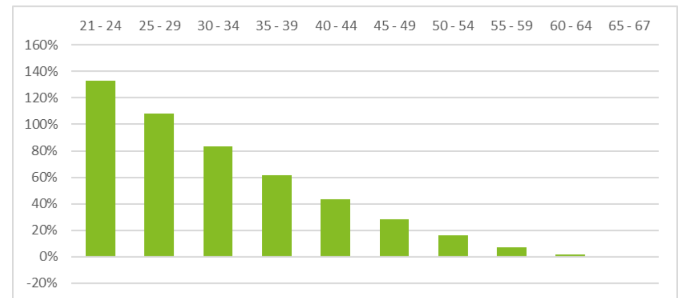
An employer may have the starting point not to let any employee to be set back in the transition to a flat-rate premium. In this case everyone either improves or stays at the same level. The figure below shows the flat-rate premium that should be used to guarantee a benefit neutral transition for all employees. This results in a flat-rate premium of 26.9%.



It is immediately visible that an age-independent premium is substantially higher than the current basis. This is because the premium contributed by the highest age cohort in the current plan is relatively high. In order to guarantee this group an equivalent future contribution, the flat-rate premium has to be set at the same level as the highest age cohort. The figure below shows the premiums if the employer switches to a horizontal premium at the height of 26.9% of the pensionable base.

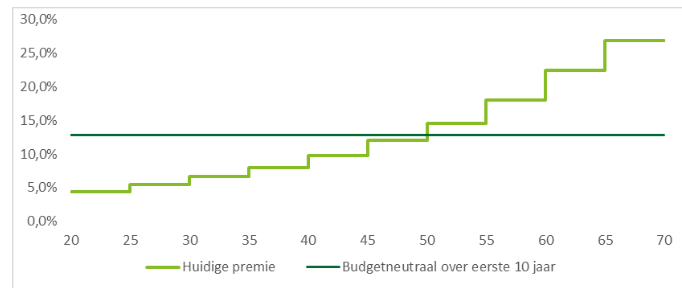


This switch would result in a considerably higher pension contribution for almost all age groups. This is illustrated by the figure below. The youngest cohort gains more than 100% in pension contribution. This scenario is not desirable nor feasable for most employers.

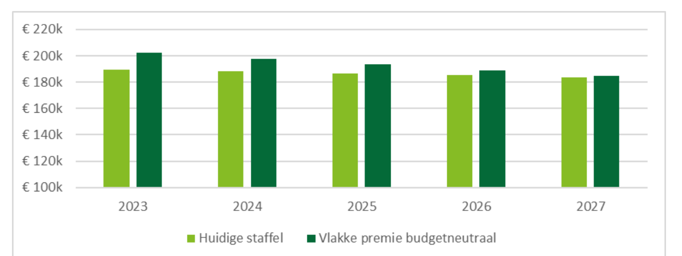


Scenario iii: A compromise solution

As shown in the budget neutral scenario, budget neutrality in year 1 results in a decline in pension capital for almost all age cohorts. To mitigate this effect, budget neutrality over the first 'x' year can be considered. The graph shows the horizontal premium if we assume budget neutrality over the first 10 years. This results in a flat-rate premium of 12.9% of the pensionable base.



As expected, this results in a higher horizontal premium than in the case of the budget neutral scenario. However, due to the increase in the premium that would take place in the current plan, this level of the horizontal premium is budget neutral over a period of 10 years. The table below shows that after 5 years a lower annual premium is required in the new plan when compared to the current plan.



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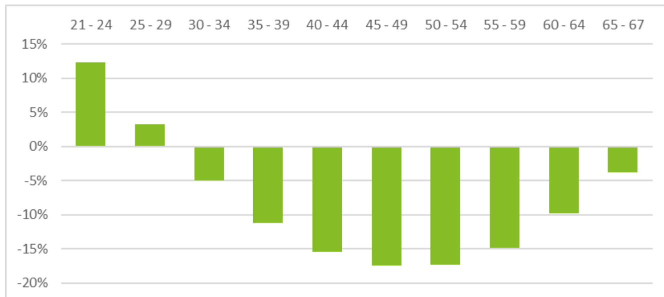
For most age cohorts, a decline in total pension capital is still visible. However, the effect has been reduced by the higher horizontal premium compared to the budget neutral scenario.



Conclusion

Where a budget neutral transition can be a logical starting point, it is important to determine what the budget neutral starting point is exactly. In this article, we show that a budget neutral transitition to a flat-rate based on the budget in year 1 results in a decrease of the future expect accrued pension capital for almost all age cohorts.For example, with budget neutrality in year 1, almost all employees will eventually be worse off. On the other hand, benefit neutrality leads to a sharp increase in premiums and virtually all employees benefit substantially. For the first age cohort (21 – 24 years old) this results in an increases of the future pension capital of more than 100%. Therefore, often a compromise solution is ought to be found where both employer and employees can agree on.

From a merger and acquisition perspective, this means that regardless of the chosen scenario, a completely cost neutral transition will often not be possible, given that transitional arrangements are not applied. Employers will need to find a balance betwee the level of compensation and a competitive compensation package on the one hand and keeping the total pension premium in check on the other hand. Therefore, in the event of a proposed merger or acquisition, it is beneficial to put the Wet toekomst pensioen on the agenda and find a balanced strategy, which will satisfy the demands of all involved stakeholders.

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