Why the lifecycle choice is essential for a good pension

How an appropriate lifecycle choice can improve employee pension capital

The new pension system, called the ‘Wet toekomst pensioenen’, is expected to come into effect on 1 July 2023. This means that each employer in the Netherlands will have until 1 January 2027 to transition to the new pension system. An important change is that all participants will have their own pension capital after the start. The lifecycle – implicitly or explicitly – plays an essential role in all these pension capitals. Collective investments are made in the Solidaire premie-regeling (‘SPR’) and the return achieved is implicitly allocated to the participants according to age cohorts. In the Flexibele premie-regeling (‘FPR’), the individual participant can choose a suitable life cycle and receive the return based on the self-selected life cycle. Employers can play an important role in informing and guiding employees towards a personally appropriate pension. In this article, we explain what a lifecycle is, how it works, and what the choices are.

What is investing according to the lifecycle principle?

Pension investments are often designed based on lifecycle theory. This theory describes people’s consumption, borrowing and saving patterns over their lifespans. It explains why young people can take more investment risk than older people and why the level of consumption remains relatively constant throughout their lives. Young people have potential earning capacity (human capital) and at the same time have a longer investment horizon to make up losses from bad years, with profits from good years through work. Later in life, fewer adjustments can be made in earning capacity, and a shorter investment horizon applies. This is also reflected in pension investments. It is therefore wise to gradually invest the financial assets in a less risky manner, for example less in risky shares and more in fixed-income securities. According to the lifecycle theory, risk and thus return should decrease with age. Figure 1 shows a simplified picture of a lifecycle.

When drawing up the lifecycle for a pension scheme, the following three factors are taken into account:

1. Start accrual – during most of the pension accrual, the ratio between risky shares and fixed-income securities is the same. Risky shares are mainly held here because the participant has both sufficient human capital and time.
2. Run-up to retirement – risk is gradually reduced by holding less risky stocks and more fixed-income securities in the run-up to retirement.
3. End accrual – at retirement the risky part reaches its lowest point and mainly fixed-income securities are held. The distribution of risky stocks and fixed-income securities depends on whether a fixed or variable distribution is purchased.

Investing in the current and new pension system

In the new pension system, the benefit agreement (DB) and the current defined contribution scheme (DC) will be replaced by the SPR or the FPR. The collective investment policy of the DB scheme is now moving towards an age-oriented investment policy in the form of a lifecycle. Changes in the SPR in the new system compared to the current DB scheme are the allocation of returns to age cohorts and the possibility of lifting the borrowing restriction. Where participants in the DB scheme are entitled to a fixed payment on the retirement date whereby investment results are shared collectively, the investment return in the SPR will be allocated according to age. The pension fund board determines these return allocation rules based on, among other things, the participants’
requested risk attitude and the fund’s composition. The senior participants are protected against possible declines in interest rates and are therefore mainly allocated a so-called notional protective return. Young people will be allocated the remainder of the return, called the excess return. This can also turn out negative. As a result, the participants within an SPR are dealing with lifecycles indirectly, meaning the participants have no individual choice in this. In the new system, pension funds also have the option of making use of the lifted borrowing restriction, which means that young people in an SPR can be exposed to investment risks for more than 100% of their weighted assets in more risky stocks. This extra capital is notionally borrowed from the more senior participants, with the returns and risks of this capital being allocated to the young people. See figure 2 for an example of a lifecycle in which more than 100% is invested in equities. The lifting of the borrowing restriction can ensure this.

**Figure 2: Lifecycles with and without borrowing restrictions**

With the new FPR, relatively few will be changing in terms of lifecycle investments compared to the current DC scheme. This is because both schemes invest through lifecycles and participants have individual pension capitals where they can make their own choices about their risk profile. If the participant does not choose, the participant will end up in the default lifecycle, a neutral lifecycle, which the pension provider believes is suitable for the average participant. In addition to the default lifecycle, there are one or more offensive and defensive lifecycles from which the participant can choose. In an offensive lifecycle, investments are riskier with a higher share of commercial securities than in the neutral lifecycle. The investments are phased out later to a higher share of fixed-income securities. It is expected that more return can be achieved in this lifecycle due to the higher risk taken, which in theory generates a higher but more volatile pension result. With a defensive lifecycle, investments are less risky and the moment of phasing out is earlier. Because less risk is taken in this lifecycle, the expected pension result is lower but more stable and certain.

In addition to the neutral, offensive, and defensive lifecycles, some pension providers offer others — for example, a passively managed or sustainable life cycle. A passive lifecycle tries to follow the market as closely as possible. Because it tracks an index, the costs for this can also be lower than with active investing. There are also mixed funds where a part is actively invested because it is expected that additional returns can be achieved on top of the market return, and the remainder is invested passively. For example, a sustainable lifecycle invests in impact funds and excludes certain funds based on sustainability principles. The latter can be important for companies that attach great importance to sustainability.

Although participants have the choice between different life cycles, the experience is that most participants do not make a choice and therefore end up in the neutral life cycle (default). Partly for this reason, an employer must choose a pension provider that offers a neutral lifecycle that fits the employee population. Pension providers are allowed to fill in their life cycles as they see fit, which results in different life cycles for the various pension providers. These differences are expressed, for example, in the distribution between different risk categories, such as fixed-income securities and equities. Or in the underlying securities in which investments are made and thus the costs of managing the funds. As a result, the pension results will differ per administrator, even under different economic circumstances. It is important that employers inform their employees about the available life cycles of the chosen contractor and activate them to make a conscious choice. This can have a significant effect on the expected pension result.

**Variable benefit**

Another choice that participants have within an FPR is the choice between a fixed or variable payment on the retirement date. This does not apply to the SPR. In the current pension system, the fixed benefit is the default option, but in the new system, administrators also have the option of using the variable benefit as the default option. Employees can decide before or on the retirement date whether they prefer a fixed pension benefit or want to continue to invest part of the pension capital during the benefit phase and thus receive a variable pension benefit. If the variable benefit is chosen, the corresponding lifecycle is adjusted. In this case, it is desirable to start the risk reduction later, so that on the retirement date more assets in the investment portfolio can be used to continue investing. Of course, risks accompany this extra potential, but if the choice for a variable benefit is made well before the retirement date, continued investment is expected to result in a higher pension. The variable benefit can also be a welcome option if the interest rate is low on the retirement date and the pension benefit level may be less than expected. Figure 3 shows two examples of life cycles, one aimed at a fixed benefit and one pre-sorted for a variable benefit. If the variable benefit has been chosen, part of the accrued pension capital is continued to be invested after retirement according to the lifecycle. In this situation too, experience shows that participants often do not make a choice and end up in the default option. It is therefore important as an employer to consider the type of benefit.

**Figure 3: Lifecycle pre-sorting for a variable payment**

Bron: Deloitte
Conclusion
Each participant will have personal pension assets in the new pension system, whereby all participants' assets are collectively invested in the SPR and in the FPR, according to personal lifecycle choices. In the SPR, pension providers will have to make choices about the allocation of the collective returns to various age cohorts and whether they want to make use of the lifting of the borrowing restriction. In the FPR, participants can choose between different life cycles and whether they want a fixed or variable benefit. Many choices can be made in advance that are relevant to the pension outcome of employees. This applies both to the design of the life cycles in which the employer has a role and to the choices that employees have about their lifecycle. However, experience learns that many employees are not expected to select a best-fit lifecycle on their initiative. It is therefore important as an employer to inform employees about the various choices and guide them towards an individually suitable pension.

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