European Pensions

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A different look

The reasoning behind France's unique approach to pension reform

The Netherlands

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Infrastructure

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September 2013

APAPR

iapf

The Irish Institute of Pensions Management

European Pensions has agreements with several associations to reach their membership. For details contact john.woods@europeanpensions.net

Editor's comment

This issue, our focus is all about change. From France's 'unique' pension reforms (p 26), to the Netherlands' not quite so assured position as the 'perfect' model of pension provision (p 20), the foundations of retirement saving are shifting all across Europe. Whether these reforms will solve the issues they aim to address, or create new problems to overcome, (as is feared with Polish reform - see p 32) remains to be seen.

Pension schemes themselves are also changing, particularly with their investment strategies. Most notable lately has been the search for steady income streams (see p 34). A potential change could also be the increased prominence of infrastructure in a pension fund's portfolio. We explore how likely this is on p 41.

With all these changes occurring, from top level reforms to individual scheme strategies, the pension landscape will look very different once the dust finally settles.

Laura Blows, editor

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France unveils latest pension reforms

PENSION CONTRIBUTION INCREASES FOR WORKERS AND EMPLOYERS

French workers and employers will have to pay more in pension contributions to address France's deficit-hit retirement system, Prime Minister Jean-Marc Ayrault has revealed.

Unveiling pension reforms after several weeks of negotiations with social partners, Ayrault said the reform will "correct the injustices" within the current system and is a structural change "ensuring the future of France's pensions".

Under the reforms, employees and businesses will have to face a 0.15 per cent contribution increase in 2014, rising to a total of 0.3 per cent in 2017.

The government has said the contribution period necessary to obtain a full state pension will increase between 2020 and 2035.

Those born in 1973 will be required to pay in for 43 years to qualify for a full contribution rate, against 41.5 years for those born in 1956. The minimum retirement age of 62 has not been raised.

"It is a responsible reform," Ayrault said. "It reflects the inescapable reality of the increase in life expectancy in our society."

Current estimates forecast that a woman retiring in 2012 at age 60 and 9 months will have an average retirement of 26 and a half years, four years more than a woman in 1982 retiring at age 60.

The number of people aged 60 and over was recorded at 12 million in 2000 and is now 15 million. It is forecast to hit 20 million in 2035. By 2020, pension funding needs will hit €21bn and by 2035 levels could reach €27bn.

"It is my responsibility to restore long term balance," Ayrault concluded. "The French are attached to their pension system and we must preserve this great heritage."

Medef head Pierre Gattaz criticised the reforms, describing them as "dangerous" and "not acceptable". Gattaz argued that "no structural problem within the current pensions system has been resolved".

He called for a deeper retirement reform to be implemented to ensure sustainability and reduce deficits within the country's pension system.

Writing in *Le Monde* before the reforms were announced, Gattaz said the country "cannot be content with half-measures" if it is to restore trust among workers, whatever their age or social status.

Medef and Gattaz called for an increase in the retirement age to 63 in France.

CGT union general secretary Thierry Lepaon said young people and pensioners are set to be the "victims" of France's pension reforms.

Speaking on French national television channel France 2, Lepaon said young people in France are likely to suffer because they will have to work for longer in order to receive a full pension. Pensioners will have to experience an increase in the CSG (contribution sociale généralisée) tax.

"The government has said it will implement a pension reform allowing younger generations to have more reassurance about their future," Lepaon said. "But it would seem that young people are set to be the most disadvantaged as a result of the reform framework as it is currently presented."

France's reforms have ignored the International Monetary Fund's recent recommendations in its annual consultation with the country, which stated the statutory retirement age should be increased along with the full-pension contribution period.

The 2010 pension reform and phasing out of various early-retirement schemes had already increased the employment rate of older workers, the IMF's report said, but further reforms "should focus on lengthening professional lives".

The European Commission in May warned France that it would need to overhaul its pension system if it were to be granted a two year extension to its deadline to cut public deficits.

The commission pushed for deep reforms, including an increase to the retirement age, prompting a stern response from President François Hollande. He said the commission cannot dictate the specifics of the country's deficit reduction programme, and it was up to France to decide how spending can be reined in.

Overall, the IMF concluded that although France's economy 'flatlined' last year, it was expected to grow through the second half of this year and over 2014.

The IMF said much of France's fiscal consolidation is expected to be completed by 2013, and the pace of adjustment should be eased in 2014.

France also announced in August that it is considering implementing a points-based retirement credit system to provide greater flexibility for workers in tough physical conditions.

Ayrault told journalists that France could turn away from a years worked tally system, changing to a structure that would enable workers to accumulate credits that would contribute to their pension.

Ayrault said the proposals would allow those working in onerous conditions to have more of a say over their exact point of retirement.

"If we want our French social model to live on, we have to take into account the high expectations of workers, in particular those who work in onerous conditions," Ayrault stated.

Written by Adam Cadle

EIOPA stands behind solvency proposals

INDEPENDENT RESEARCH SUGGESTS PROPOSALS MAY STRUGGLE THROUGH POLITICAL PROCESS

European regulators remain convinced new solvency rules would strengthen pension provision, but new research has cast doubt over whether the changes would ever make it through the legislative process.

The directive covering occupational pensions, 'IORPs', is currently under review and the European Commission had proposed to introduce new capital adequacy requirements alongside a 'holistic balance sheet' approach to assessing the strength of scheme funding.

The solvency proposals have now been dropped from the updated directive, which is expected to be introduced in autumn. The EC's commissioner for internal market services Michel Barnier announced the change, citing a need for more complete data before the proposals could go ahead.

However, J.P. Morgan Asset Management subsequently published research indicating that widespread political opposition to the proposals would have prevented them from proceeding.

J.P. Morgan's research indicates that the opposition of Germany, the UK, the Netherlands, Belgium and Ireland meant the proposals would not have passed a vote when the next version of the IORP directive is introduced.

"A key reason that the solvency requirement was dropped from the draft IORP directive is that it would have been hard to get it through the Council of Ministers," European head of strategy Paul Sweeting said. "The five countries opposing the directive had a total of 90 votes, and only 91 votes were needed for a blocking minority. The abstention of any other country in the EU would therefore have derailed the directive."

The opposition means that a future vote on the proposals is unlikely to pass, J.P. Morgan found. Although the current system of voting weights will be dropped by 2017, the new voting system would still make it very difficult for the commission to pass the solvency rules.

"The Lisbon rules, which do away with voting weights in 2017, won't make it much easier," Sweeting said.

"Under those rules, for legislation to be blocked, it must be opposed by countries whose inhabitants together account for 35 per cent of the total EU population – and we estimate that the five opposing countries will account for 34.87 per cent of the populace, only a few hundred thousand short of a blocking minority."

Although Croatia's recent inclusion in the European Union increased the number of votes required to block legislation, Sweeting said country's entry does not significantly change the situation.

"The number of votes needed for a blocking minority increases slightly, to 93. However, even the smallest country in the EU, Malta, has three votes, so it will be no more difficult than before to block this legislation."

Opposition to the proposals did not extend to the European Insurance and Occupational Pensions Authority, which in July announced it remained "convinced" the holistic balance sheet approach can strengthen pension provision.

EIOPA said the holistic balance sheet can contribute to the sustainability of pension funds and the protection of current and future generations. This is in line with the EU policy objective to provide citizens with adequate, sustainable, and secure pensions.

The statements came as the regulator published its final report on the quantitative impact study it prepared on the options for a holistic balance sheet approach.

The QIS was carried out at the request of the European Commission, and EIOPA chair Gabriel Bernardino said the study was an important step in developing a better understanding of the financial position of EU pensions.

"The ability of many IORPs to provide benefits is under significant pressure as a result of historically low interest rates, market volatility, improving longevity as well as economic pressure on participants and sponsoring employers," he said.

Controversy has surrounded the holistic balance sheet proposals, and the Solvency II-style capital requirements they underpin. Many have argued that a single system of assessing pension funds' financial health across markets is not possible due to legal and market differences between jurisdictions.

A study from consultancy LCP in August found that the cost of the new solvency requirements would equal almost half of gross domestic product in the United Kingdom.

In contrast, Germany and Ireland would both be hit by just 2 per cent of GDP and Belgium by 1 per cent.

IORPs had to value all assets and liabilities on the holistic balance sheet on a market consistent basis for the QIS. In addition, IORPs were asked to recognise the value of sponsor support arrangements, pension protection schemes and benefit adjustment mechanisms available to them.

EIOPA said the QIS provides a transparent view of how far occupational pension promises are supported by financial assets and security mechanisms. It revealed a wide variation in funding strength between member states.

"The holistic balance sheet which underlies this QIS is an opportunity to develop a risk based measurement of all of the elements which affect the cost of providing benefits as well as all mechanisms which fund those benefits or contribute to their security," Bernardino said.

Written by Matt Ritchie and Peter Davy

Bank of Ireland keeps life and pensions arm

BOI ANNOUNCES 8% PROFIT INCREASE IN THE SAME AREA

The Bank of Ireland, one of the country's big four banks, will not have to sell life and pensions arm New Ireland Assurance in a rare reversal of an order for divestment.

The company, which has €12bn in assets under management, was to be divested under orders of the European Commission following Bank of Ireland's receipt of €3.8bn state aid in 2010. That came after the bank set aside more than €15bn to cover bad loans resulting from Ireland's property market crash.

However, changes to the bank's restructuring plan have been approved by the commission, which has announced it can keep its life and pensions arm.

According to the commission's announcement, the recently approved sale of Irish Life – the country's largest life insurance company – to Canada Life has limited the potential buyers, increasing the chances of selling at a loss.

"Such a divestment would negatively affect BOI's capital and capacity to return to profitability and would slow down progress towards long term viability," it said in the release.

The Bank of Ireland remains the only Irish bank not majority-owned by the state, which has a 15 per cent stake in the bank.

Improved performance from the life and pensions business have helped drive an 8 per cent increase in profit for the Bank of Ireland in the six months to June.

The bank's interim results show operating profit of €42m for the period, with operating income up 4 per cent to €88m.

"Sales volumes were up in both pension and single premium life products and total new business margins were higher than the same period in 2012," the bank said.

The Ireland-, London-, and New York-listed bank's defined benefit schemes were €1.05bn in deficit at June 30, compared with €1.07bn at the end of December.

"The group continues to work on actions to mitigate the current deficit in the defined benefit pension schemes and is actively engaging with the relevant staff representative bodies and other stakeholders," the bank said.

Pension costs for the six months were €79m, €22m higher than the same period in 2012. Around €15m of the increase was attributed to the greater impact of the adoption of IAS 19 accounting standards, with the remainder of the increase attributed to the higher pension deficit and lower discount rates.

Written by Peter Davy and Matt Ritchie

Pension Board expresses concerns over DC market

IRELAND'S REGULATOR SAYS COSTS, COMMUNICATIONS AND SCALE MUST BE ADDRESSED

Most Irish defined contribution schemes have too few members to have bargaining power with providers, and there are too many schemes for The Pensions Board to supervise to an adequate standard, the country's pensions regulator has found.

Ireland's Pensions Board published a consultation in August on the DC market in the country, as part of a review of the regulation and future structure of DC provision.

The document outlined the regulator's concerns with the current market. It said there are too many schemes where the costs borne by the members are too high, and could be lower.

Investment choices on offer too often do not take account of the level of investment understanding and experience of members, The Pensions Board said, and the default investment strategies of too many schemes appeared to "expose members to unexpected amounts of risk".

Member communications were also a concern, as was the lack of independent oversight of the collection and remittance of contributions in schemes where the employer acts as trustee.

Where the trustee is connected to the administration or investment provider, there is no scope for challenge on costs, investment performance or administrative performance.

The Pensions Board chief executive Brendan Kennedy said the outcome of the consultation would form an important part in the board's review of DC provision, which may ultimately lead to proposals for legislative change.

"The board would like to hear from trustees, providers, managers, advisers and other interested stakeholders."

The board is seeking input on what industry figures regard as minimum standards for trustee knowledge, understanding and behaviour and whether the regulator should issue a code of governance clarifying the standards it expects of DC trustees.

Suggestions as to how the regulator can ensure that defaults offered are appropriate and do not expose members to unnecessary and unexpected amounts of risk will also be considered.

Concerning improvements surrounding member communication, the consultation document revealed the Irish Pensions Board will analyse responses on how costs and charges borne by members can be made more clear and how they can be transparently communicated to members.

Written by Matt Ritchie

Finnish state pension costs reach nearly 14% of GNP

SURPRISING INCREASE IN AVERAGE EXPECTED RETIREMENT AGE LAST YEAR

Statutory pension expenditure in Finland is forecast to reach €26.6bn this year, according to the Finnish Centre for Pensions, 13.6 per cent of estimated gross national product.

New forecasts from the statutory body show public pension expenditure increasing by 6 per cent this year.

"A large part of this growth can be explained by the growth in old-age pension expenditure," the centre said. "Growth is impeded by the discontinuation of the unemployment pension as well as the estimated decrease in disability and part-time pensions."

Earnings-related pension recipients in the country are expected to number around 1,405,000 by the end of this year, up 1.1 per cent year-on-year.

The statutory body showed pension recipients in the private sector will number 1,235,000, whereas those in the public sector are expected to number 696,000.

Separate analysis showed the average effective retirement age in the earnings-related pension scheme was 60.9 years last year, up 0.4 years from the previous year. The effective retirement age has risen by two years from the level prior to recent pension reform, exceeding forecasts.

Finnish Centre for Pensions director Mikko Kautto said there could be several reasons for the increase.

"A majority of those representing the large age cohorts have already retired. The employment rate of the ageing continued to rise also in 2012. The number of pension applications decreased, especially where the municipal pension scheme is concerned. Fewer people also retired on a disability pension than before," Kautto said.

Statutory pensions in Finland consist of the defined benefit earnings-related pension, a residence-based national pension, and a guarantee that ensures a minimum level of security.

The total number of new pensioners dropped significantly last year compared to 2011, and the decrease was reflected in the number of pension applications. Last year was the first year when new unemployment pensions were no longer granted.

Legislative changes also saw a few thousand people retire on an old-age pension straight from a long-term unemployment allowance last year.

The advance estimate of the Finnish Centre for Pensions was for the forecast to have remained virtually unchanged, and Kautto said the increase was surprisingly large.

"The long-term trend is more important than the figures of just one year, since various changes can take place in the process of retirement and registration," Kautto said.

Written by Matt Ritchie

OECD urges action on Austrian pension system

INDUSTRY ASSOCIATION FINDS POSITIVE PENSION FUND PERFORMANCE IN FIRST HALF

Further action is needed to enable the Austrian pension system to meet the challenges posed by the country's ageing population, the OECD has said.

Public pension spending is already above 12 per cent in the central European country, the organisation said, and is projected to stabilise at 14 per cent from 2030. This represents one of the highest spending shares in the OECD.

"While the pensions policy framework is today on a sound foundation, it continues to display certain important uncertainties and shortcomings," the OECD said.

Identifying and reducing obstacles to people working into older age was highlighted as a priority issue.

Previous pension reforms sought to improve labour force participation, and have achieved some success. However, the OECD said the share of older workers in the country remains "comparatively low" and more can be done.

Austria was urged to improve the transparency of the redistributive and contribution-related elements of its pension system.

The "still complex" pension system results in potentially high cross-subsidisation across cohorts, professional groups, income categories, married and single contributors, and survivors, the OECD said in its economic survey of Austria.

"To improve the evidence base for future pension measures, 'redistributive' and 'deferred saving' elements should be calculated. The Pension Commission should be mandated with this task."

Statistics from the Austrian Pension Fund Association showed investments by the country's funds returned an average of 2.19 per cent over the second quarter of 2013, lifting returns for first half of 2013 to 0.82 per cent.

The association said pension fund performance had been satisfactory, considering the difficult economic environment.

"The performance clearly shows that the investments of pension funds follows a tension between security and income, so that the turbulence on the capital markets in June did not affect the results in full extent," chair Andreas Zakostelsky said.

Written by Matt Ritchie and Ilonka Oudenampsen

Irish funds return to growth in July

FUNDS TURN AROUND AFTER FIRST NEGATIVE PERFORMANCE IN MONTHS IN JUNE

Irish pension funds returned to growth during July, after declining in June for the first time since October last year.

Figures from Rubicon Investment Consulting showed Irish managed pension funds had an average return of 2.7 per cent over July.

Irish Life Investment Managers and Standard Life Investments shared top position with returns of 3.2 per cent for the month, while Prescient Investment Managers and Merrion Investment Managers had the lowest returns at 2.1 per cent.

Setanta Asset Management led the market in June with returns of -2.3 per cent while Irish Life finished bottom with a return of -3.2 per cent.

Aviva Investors and Merrion produced returns of -3.1 per cent, while Standard Life and Zurich Life returned -2.8 per cent.

Six of the past seven months have seen funds make gains, and managed funds have now returned 9.6 per cent on average so far this year.

Setanta delivered the strongest return over the year to date at 13.4 per cent, while Merrion Investment Managers produced the weakest return at 8.1 per cent.

The average fund return was 13.6 per cent over the past 12 months.

Written by Matt Ritchie and Adam Cadle

Disappointing second quarter for Dutch funds

BIGGEST FUNDS MULL BENEFIT AND ENTITLEMENT CUTS

Dutch pension funds had a disappointing second quarter, as the low interest rate and negative investment returns resulted in a fall in coverage ratios.

ABP saw its coverage ratio fall 4 per cent to 97 per cent, while PME fell 4.9 per cent to 96.6 per cent and PMT dropped 4.8 per cent to 96.3 per cent.

All three funds believe that it is unlikely that they will be able to meet their funding target by the end of 2013. If this is the case, they will have to cut benefits and pension rights for a second time next April, after the first cuts were made this year.

Two of the other big funds in the Netherlands - Pensioenfonds Zorg en Welzijn and building sector pension fund BPF - hope they can avoid the cuts. However, PFZW is considering the possibility of reducing rights and benefits after its coverage ratio dropped to 101 per cent. Of the five funds, BPF is in the best position, with a coverage ratio of 103.9 per cent.

Most funds have warned their members that further benefit and rights cuts are increasingly likely, despite financial markets recovering slightly and interest rates having increased over the past few weeks.

Written by Ilonka Oudenampsen

Portuguese pension assets fall in Q2

MUTUAL FUNDS FALL IN JULY, BUT UP FOR THE YEAR

Portuguese net pension asset values fell 0.7 per cent over the June quarter, to €14.01bn.

The Portuguese pension fund association, APFIPP, released statistics showing the net asset position fell from €14.12bn at the end of the three months to March. This compares to €14.07bn at the end of the December quarter and €12.96bn at the end of the June quarter last year.

The number of funds also fell quarter on quarter, with three funds departing to leave a total of 189. There were 184 funds in activity at the end of the December quarter, and 188 at the end of the June quarter last year.

Pensõesgere was the management company with the largest market share, with total net assets of €4.17bn. The firm holds 29.8 per cent of the Portuguese pension fund market. CGD Pensões ranks second, with assets of €2.28bn and a market share of 16.3 percent.

SGF registered the highest increase, with 1.5 per cent growth over the previous quarter. The largest growth in total net assets belonged to Pensõesgere, which added €11.2m, or 0.3 per cent.

Meanwhile, APFIPP figures showed net assets of Portuguese mutual funds fell 1.2 per cent over July, finishing the month at €13.3bn. Although assets fell over the past month they had increased by 8.6 per cent since December, and 19.4 per cent since last July.

Written by Matt Ritchie

Swiss pension funding levels fall

FALLING ASSET VALUES SEES SCHEME FUNDING SLIP SLIGHTLY

Swiss pension funds' financing situation showed a slight deterioration for the second quarter, due to price falls in shares and bonds in June, but nevertheless maintained cover ratios of more than 100 per cent.

Swisscanto's latest pension fund monitor as at 30 June 2013 showed that for private-law pension funds, the asset-weighted cover ratios fell by 1.7 percentage points to 111.3 per cent compared to Q1.

For fully capitalised public-law pension funds, the cover ratio also fell by 1.7 percentage points to 101.4 per cent.

The estimated proportion of private-law funds with a coverage shortfall was around 6 per cent, compared to fully capitalised public-law funds which had a shortfall of 44 per cent.

Public-law funds, like private-law funds, have to build a fluctuation reserve and also strive for a cover ratio of greater than 100 per cent.

For public-law funds with a government guarantee, a partial capitalisation level of 80 per cent is permitted. In the case of these funds, the asset-weighted cover ratio fell by one percentage point to 75.2 per cent.

Figures are based on 343 pension institutions with total assets of CHF 481bn.

Written by Adam Cadle

Improvement in UK DB scheme funding in July

STRONG MARKETS AND CONTRIBUTIONS FAIL TO IMPROVE FTSE 100 SCHEME FUNDING IN 2012

A lift in equity values offset a fall in gilt yields to improve the funding position of the UK's defined benefit schemes in July, according to figures from the Pension Protection Fund.

The latest PPF 7800 index, covering the 6,316 schemes eligible for entry to the UK's statutory lifeboat fund, showed the aggregate deficit of the relevant schemes fell by around 14 per cent to £115.7bn in July. The overall deficit was £292.6bn at the end of July last year.

There were 4,568 schemes in deficit, compared with 4,692 schemes at the end of June and 5,314 schemes last July. The overall funding ratio improved from 89.1 per cent to 90.7 per cent.

Assets rose by 2.7 per cent to £1.13trn over the month, which the PPF attributed largely to rising equity markets. The UK FTSE All Share index rose by 6.7 per cent over July, and 19.9 per cent over the previous 12 months.

Liabilities increased by 0.9 per cent to £1.25trn over the month, as 15-year gilt yields fell by 6 basis points and 15 year index linked gilt yields stayed the same. Over the year to July 15 year gilt yields were up by 91 basis points.

Separate analysis from consultancy LCP showed that schemes sponsored by FTSE 100 companies saw little change in their deficits last year overall, despite good investment returns and billions in sponsor contributions.

The consultancy's twentieth annual *Accounting for Pensions* report found the deficit for FTSE 100 companies' schemes rose £1bn to sit at £43bn last year. This is despite sponsors pouring some £21.9bn into their DB plans.

Scheme assets of around £447bn were outstripped by liabilities of about £490bn when measured by the international accounting standard for employee benefits.

LCP partner and author of the report Bob Scott said pension planning was subject to "seemingly constant" regulatory and legislative change, a familiar trend over the 20 years the firm has been preparing the reports.

"In the past 12 months alone we have seen the re-introduction of auto-enrolment; the announcement of a flat-rate state pension and the end of contracting-out; and further changes to the IAS19 accounting standard. Is it any wonder that the past 20 years have seen traditional final salary pension schemes phased out to be replaced largely by lower-quality defined contribution schemes?"

The report found falling bond yields had led schemes to increase their allocations to equities, with the asset class comprising 36.4 per cent of schemes' portfolios compared with 34.8 per cent last year.

Low yields had also meant higher funding targets and deficits, LCP said. The firm welcomed the Department for Work and Pensions' rejection of calls to allow 'smoothing' of assets in funding valuations.

Scott said that with liabilities high and rising against a backdrop of "constant" legislative change, many companies will be hoping to completely remove pensions risk from their balance sheets over the next 20 years.

"This may be good news for their shareholders but is unlikely to improve the lot of those employees who are relying on good workplace pensions for their retirement."

Written by Matt Ritchie

PensionDanmark power plant deal

DANISH FUND INVESTS £128M IN ENGLISH BIOMASS PLANT

PensionDanmark has partnered with Burmeister & Wain Scandinavian Contractor in a £160m new-build biomass power plant to be constructed in Lincolnshire, England.

PensionDanmark's share of the investment is £128m, funded via the Copenhagen Infrastructure I fund. The fund was established in 2012 and is administered by Copenhagen Infrastructure Partners (CIP).

BWSC's share of the investment is £32m. The Danish engineering and contracting firm will build, operate and maintain the plant, which is expected to be operational from early 2016.

PensionDanmark manages pensions under collective and corporate agreements and health care products on behalf of 630,000 members in 25,000 public and private sector businesses. Chief executive Torben Möger Pedersen said the project's investment model provides the fund with an attractive return with limited risk.

"The risk is limited by the fact that the majority of PensionDanmark's investment is in the form of loans and the bulk of earnings are regulated, with the costs fixed via long-term contracts."

PensionDanmark has DKK 6bn directly invested in infrastructure, and expects to invest a further DKK 12bn over the next four years. The majority will be in energy-related infrastructure and half will be invested via Copenhagen Infrastructure I, in which PensionDanmark is the sole investor.

CIP was established in October 2012 with PensionDanmark as seed investor of DKK 6bn in its first fund, Copenhagen Infrastructure I K/S.

Written by Matt Ritchie

Investors' equity appetite returns

APPEAL OF FIXED INCOME DIMINISHES

Almost two thirds of investors across Europe see equities as the most appealing asset class over the next 12 months, up from 35 per cent in 2012.

Sixty-two per cent of investors said they had a greater appetite for equities with nearly a third citing them as the most compelling emerging market asset class, according to MHP's latest European pensions and investment industry survey.

Less than 5 per cent opted for fixed income as the most compelling asset class over the next 12 months, down from 18 per cent in 2012.

Hedge funds gained 16 per cent of the vote, and there was much broader acceptance that some element of leverage is essential if investors are to meet their return targets.

Less than 15 per cent of respondents thought any form of leverage was unjustifiable.

MHP Financial managing director Sally Todd said: "The impression given is that investors, while all too aware of the ongoing vulnerability to the possibility of harmful impacts from external shocks and EU regulation, are nonetheless developing an appetite for riskier assets and prudent leverage."

Systemic risk was cited as a significant worry for 65 per cent of respondents.

Seventy-two senior figures at European pension funds, consultants and investment management houses were surveyed between July and August 2013.

Written by Adam Cadle

European Pensions news in brief

• **Legal & General Investment Management (LGIM)** has launched a new index fund for pension fund investors seeking emerging market exposure. The LGIM Russell Developed Large Cap EM GeoExposure Index Fund is designed for investors who want to benefit from the economic growth expected in emerging markets, but without some of the risks involved in direct investment.

• **KPMG International** has produced *AIFMD: Transposition Status*, an overview of the status and requirements for AIFMs in the EU. KPMG's publication provides an overview of the impact of AIFMD with country by country status for Denmark, Finland, France, Germany, Ireland, Luxembourg, Netherlands, Spain, Sweden, and the United Kingdom.

• **Morgan Stanley Investment Management** has announced the launch of the Morgan Stanley Investment Funds Global Quality Fund. Global Quality will look to generate attractive returns through investing in high quality companies with an inherent economic robustness and will have the primary goal of compounding investors' assets over time.

• **Fidelity Worldwide Investment** has appointed **Pitmans Trustees** as its master trust professional trustee in a move which will see the governance of the scheme run independently of Fidelity. Fidelity has taken the decision to do this in order to reflect absolute best practice in line with the regulator's requirements around governance.

• **Cordea Savills** has formed a full service investment platform in Japan. The firm will service clients looking to invest in Japan, an increasingly favoured destination for capital and will work closely with Savills Asset Advisory.

Push for greater supervision of longevity risk market

BANK FOR INTERNATIONAL SETTLEMENTS CALLS FOR COOPERATION ON MARKET SUPERVISION

The Bank for International Settlements (BIS) is consulting on a series of proposals for dealing with the challenges and issues facing the longevity risk transfer market.

In a preliminary study of longevity markets, the BIS finds the level of activity is not yet sizeable enough to present immediate systemic concerns, but the "massive potential size" of the market and growing interest from investment banks "make it important to ensure that these markets are safe, both on a prudential and systemic level".

Thomas Schmitz-Lippert, chair of the joint forum of bank, insurance, and securities supervisors who prepared the report, said: "By focusing today on the risks and issues related to emerging longevity risk transfer markets, the joint forum is helping global policymakers and supervisors remain ahead of the curve as these markets continue to grow."

Although almost all longevity risk transfer activity had occurred in the UK to date, the BIS found that more recently significant transactions had been completed in the Netherlands and United States.

The report argued that policymakers should consider ensuring institutions taking on longevity risk - including pension fund sponsors - are able to withstand unexpected and expected increases in life expectancy.

Policymakers were urged to "closely monitor" risk transfers between corporates, banks, insurers and the financial markets, including the amount and nature of the longevity risk transferred, and the interconnectedness this gives rise to.

The forum recommended supervisors communicate and cooperate on longevity risk transfer "internationally and cross-sectorally", in an effort to reduce the potential for regulatory arbitrage.

Supervisors should also seek to ensure that holders of longevity risk under their supervision have the appropriate knowledge, skills, expertise and information to manage it, the report said.

Supervisors should take into account that longevity swaps may expose the banking sector to longevity tail risk, possibly leading to risk transfer chain breakdowns.

The forum recommended policymakers review policies regarding where longevity risk should reside to inform their policy towards longevity risk transfer (LRT) markets.

"They should also be aware that social policies may have consequences on both longevity risk management practices and the functioning of LRT markets," the report said.

The report said policymakers should support and foster the compilation and dissemination of more "granular and up-to-date" longevity and mortality data, relevant to the valuations of pension and life insurance liabilities.

Finally, policymakers were urged to review rules and regulations regarding the measurement, management and disclosure of longevity risk, to establish or maintain high qualitative and quantitative standards.

The BIS is consulting on the proposals until 18 October.

Written by Matt Ritchie

Number of cross-border schemes falls

VALUE OF EURO AREA PENSION FUNDS INCREASES

The number of pension funds operating across European borders fell in the 12 months to June, new statistics show.

Two new cross-border institutions for occupational retirement provision were reported in the past year, but this was offset by four IORPs being withdrawn, according to data published by the European Insurance and Occupational Pensions Authority.

Overall, the number of IORPs operating cross-border fell from 84 to 82. In one case, a fund had previously been included as a new cross-border IORP when in fact it had only expanded its scope of operation into a new member state.

The number of countries in which an IORP has its registered office and/or main administration, or 'home states', stayed at nine. This is the third year where there have been nine home states, after the figure rose from seven in 2010.

The number of host states fell by three to 19, after the cross-border activities of a Luxembourg-based IORP that had Denmark, Estonia and Finland as host states were ceased.

Meanwhile, European Central Bank figures showed financial assets of euro area pension funds reached €1.74trn in the first quarter, up from €1.71trn at the end of last year.

Total financial assets of euro area insurance corporations and pension funds increased to €7.84trn in the first three months of the year, up from €7.63trn in the previous quarter.

Securities other than shares accounted for 40 per cent of assets of insurance corporations and pension funds at the end of March, and the net equity of households in pension fund reserves increased by €28bn during the quarter. Shares and other equity increased from €183bn to €185bn during this time.

Written by Adam Cadle and Matt Ritchie

Irish Pensions AWARDS 2013

Irish Pensions Awards – Shortlist Announcement

Awards Gala Dinner and Ceremony

27 November 2013

Doubletree by Hilton Dublin, Burlington Road, Ireland

Congratulations to this year's finalists!

The 2013 Irish Pensions Awards shortlist has been announced, following a record number of entries from key firms in the Irish Pensions industry. The extensive judging panel will be deciding the winners, which will be announced at a huge gala dinner in Dublin on the 27th November.
Thank you to all who entered.

2013 SHORTLIST

1. Pension Scheme of the Year

Allianz
Hewlett-Packard Ireland Defined Contribution Plan
Microsoft
Oracle

2. Pension Scheme Innovation

AllianceBernstein
Allianz

3. Best Use of Risk Management

Allianz
Guinness Ireland Group Pension Scheme

4. Best Communication Strategy

Allianz
Aviva Ireland (with Towers Watson)
Construction Executive Retirement Savings

5. Pensions Consultancy of the Year

Acumen & Trust
bfinance
IFG Corporate Pensions
ITC Consulting
Lane Clark & Peacock Ireland
Mercer

6. Investment Manager of the Year

Ashmore Group
IFG Corporate Pensions
Irish Life Investment Managers
Russell Investments
Setanta Asset Management
Standard Life Investments

7. Equities Manager of the Year

Ashmore Group
Irish Life Investment Managers
MFS Investment Management
Russell Investments
Setanta Asset Management Ltd
Threadneedle Investments
Vontobel Asset Management

8. Fixed Income Manager of the Year

Ashmore Group
Irish Life Investment Managers
Pioneer Investments
Standard Life Investments

9. Property Manager of the Year

Irish Life Investment Managers
Threadneedle Investments

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See the winners exclusively announced:

The winners will be announced at a glittering black tie Awards Gala, an evening that brings together hundreds of pension professionals for a night of networking and celebration.

The Awards are a great way to recognise and reward staff for their hard work, catch up with friends in the industry, and to develop client relationships. Consisting of a champagne reception, sumptuous dinner, awards ceremony hosted by *RTE'S New Comedy Award Winner Neil Delamere* and after show party, the Irish Pensions Awards 2013 will be a night to remember.

Early booking is advised to avoid disappointment. Book your table now to secure the best positions in the room (tables are allocated closest to the stage on a first booked basis).

How to book:

Booking is quick and easy - please complete the booking form at **www.europeanpensions.net/irishawards**

10. Alternatives Investment Manager of the Year

BCP Asset Management
Irish Life Investment Managers

11. Law Firm of the Year

Arthur Cox
Eversheds
William Fry

12. Pension Scheme Administration of the Year

Allianz
Capita Employee Benefits
IFG Corporate Pensions
Independent Trustee Company Ltd
Irish Life Corporate Business
Mercer

13. Communication Award

Acumen & Trust
Ferrier Pearce
IFG Corporate Pensions
Independent Trustee Company Ltd
Irish Life Corporate Business
Mercer

14. Innovation Award

BCP Asset Management
bfinance
Ferrier Pearce
Independent Trustee Company Ltd
Independent Trustee Limited
Irish Life Corporate Business
Mercer
Pension Source
Prescient Investment Managers (Ireland)
Profund Solutions Limited

15. Custodian of the Year

To be announced on the evening

16. Irish Pensions Personality of the Year

To be announced on the evening

17. Independent Retail Pension Broker / Pensions IFA of the Year

To be announced on the evening

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Irish Pensions AWARDS 2013

People on the move...

LATEST NEWS OF PEOPLE ON THE MOVE

Ousmène Mandeng

Pramerica Investment Management has named Ousmène Mandeng a managing director for its global institutions relations group. He will focus on expanding and developing relationships with key sovereign wealth funds, central banks and and other financial public sector institutions around the world. Mandeng joins from UBS.

Louis de Montpellier

State Street Global Advisors has announced the appointment of Louis de Montpellier as global head of SSgA's official institutions group (OIG). De Montpellier joins from the Bank for International Settlements in Switzerland, where he has been deputy head of the banking department since 2005. De Montpellier succeeds John Nugée.

Christophe Morel

Lombard Odier has strengthened its Asia-Pacific leadership team with the appointment of Christophe Morel as chief risk officer. Morel has been with Lombard Odier since 2000 and is relocating to Hong Kong from his current position of senior vice president of Lombard Odier Group's Internal Audit Department in Geneva. He has also worked at UBS.

Justin Onuekwusi

Legal & General Investment Management (LGIM) has announced the appointment of Justin Onuekwusi as a fund manager focusing on the firm's retail and risk-profiled multi-asset funds. He joins LGIM's 18-strong strategic investment and risk management (SIRM) team, which specialises in multi-asset solutions and pooled funds.

Damian Brannan

Stenham Asset Management has announced that it has hired Damian Brannan to the position of managing director. Brannan has over 22 years' investment experience and will be a member of Stenham's Investment Advisory Committee. Brannan was most recently head of hedge fund advisory, UK and Asia, at Union Bancaire Privée (UBP).

Mike Clark

Russell Investments has appointed Mike Clark as director of responsible investment. Clark will be based in London for this global role. Clark's prime responsibilities will be to lead and support the development of Russell's responsible investment capa-bilites and the promotion of sustainable work practices. He will continue to chair the Russell Sustainability Council.

Greg Saichin

Allianz Global Investors has announced the appointment of Greg Saichin, an emerging market debt specialist. Saichin has over 20 years' experience of emerging markets, 13 as a portfolio manager, and has previously worked at Pioneer Investments where he was head of emerging markets and high yield fixed income portfolio management.

Thomas Fekete

iShares, the exchange-traded funds (ETF) platform of BlackRock, has appointed Tom Fekete as head of product development in Europe, the Middle East and Africa (EMEA), effective immediately. He is responsible for driving the expansion of iShares' innovative product range and continuing to develop and deliver high quality products for investors' needs.

Diary dates: September 2013 onwards

VISIT WWW.EUROPEANPENSIONS.NET FOR MORE DIARY LISTINGS

SPS Investment Strategies in a Risk Framework for Pension Funds

19 September 2013

Wyndham Apollo Hotel, Amsterdam, Holland

This conference will provide a pension fund risk management focus for pension funds and institutional investors. Pension funds will be offered advice on how to adapt their investment strategies to accommodate different risk approaches and will look at liability and other general pension fund management issues, within the context of Dutch regulations. The theme of diversification will also be discussed away from the more mainstream asset classes such as bonds and equities.

MORE INFO: www.spsconferences.com

NAPF annual conference and exhibition 2013

16-18 October 2013

Manchester Central, UK

The National Association of Pension Funds annual conference and exhibition provides an opportunity to hear from senior leaders from pensions, business and politics, whilst also giving attendees an update on the latest thinking and updates in the pensions world. The focus will be on UK issues, such as lessons from the first year of auto-enrolment and generally the changes associated with the defined contribution and defined benefit spheres. The conference will also outline what can be learnt from the very best pension provision from around the world and how that can be incorporated into the UK pensions landscape. The conference will include keynote speeches, streamed focus sessions, fringe meetings, a trustee learning zone and a conference gala dinner.

MORE INFO: www.napf.co.uk

WorldPensionSummit 2013

13-14 November

The Muziekgebouw aan't IJ & BIM Huis, Amsterdam, Holland

The WorldPensionSummit 2013 will aim to provide analysis and insights into the many 'crossroads in pensions'. Key figures in the field of retirement management, pension fund strategy, social security and employee benefits will be in attendance. The theme this year is 'shaping tomorrow's pensions' dealing with pension investments and risk management, pension scheme development, pensions administration and much more.

MORE INFO: www.worldpensionsummit.com

Irish Pension Awards 2013

27 November 2013

Burlington Hotel, Dublin, Ireland

Now in its second year, the Irish Pensions Awards in association with *European Pensions*, aim to give recognition to those pension funds and providers who have proved their excellence, professionalism and dedication to maintaining high standards of Irish pension provision. The event will honour the pension funds, small and large, DB and DC, as well as the investment firms, consultancies and pension providers that have set the professional standards in order to best serve Irish pension funds in these ever challenging times.

MORE INFO: www.europeanpensions.net/irishawards/

Shorex Wealth Management Forum Geneva 2013

4 December

Grand Hotel Kempinski, Geneva, Switzerland

The Shorex Wealth Management Forum Geneva will provide a networking platform for independent asset managers, fund of funds, professional investors, private banks and trustees. It will also deliver knowledge updates from leading industry figures and explore key themes such as Asian equity, equity finance arbitrage, real estate investing, eurozone bonds, commodities, FATCA, gold and precious metals, strategic asset allocation and ESG integration.

MORE INFO: www.shorexgeneva.com

Mercer Global Investment Forum 2013

10-11 December

Hotel Okura, Amsterdam, Holland

The theme for Mercer's Global Investment Forums 2013 is 'smart investing in a low growth world'. The forums will explore how to invest smartly and maximise the opportunities available to long-term investors despite the subdued economic environment in Europe. Opportunities include capitalising through taking a long-term investment approach, designing smarter exposures and capturing the equity risk premium, focusing on sustainability, introducing optionality to portfolios, de-risking intelligently, behaving dynamically and demanding more from active management. Institutional investors and fund managers gather together to transfer knowledge, share ideas and network.

MORE INFO: www.mercersignatureevents.com

Shortage of guilders for the next generation

ROGIER VAN AART LOOKS AT THE CURRENT CRISIS IN THE DUTCH PENSION SECTOR AND WHAT NEEDS TO BE DONE TO OVERCOME THIS SITUATION

The disadvantage of the Dutch pension fund sector has gradually become clear in the aftermath of the global financial crisis. The average surplus ratio decreased from 132 per cent in 2008 to 105 per cent in the first quarter of 2013, the level just above the minimum legal requirement. In the interim, average surplus ratios dipped below 100 per cent. Some pension funds even had surplus ratios below 90 per cent. Even with pension assets at €1,200 billion (160 per cent of Dutch GDP), there is a crisis in the Dutch pension world. Compare this with the average ratio for the 13 largest developed economies, where pension assets make up 78 per cent of GDP.

The Netherlands is known for tulips, soccer players and one of the best and most robust pension systems in the world. But the famous pension system is having a hard time. The foundations of the system are perhaps not as equally robust as previously thought. The pension system is based on three pillars: a public 'pay-as-you-go' system, private pension funds, and individual savings. The second pillar is the strongest and wealthiest of the three. It's well established because of its independent structure and the powerful regulations that govern the collective pension funds. Relatively cheap execution and a high degree of certainty are the key benefits. Recent innovations (fiduciary management) have contributed to the global fame of the Dutch pension system.

However, this second pillar is now under pressure. The largest of the three that underpins the Dutch pension fund sector is mostly set up as a collective defined benefit system. This system has made it possible for millions of retirees to enjoy high and stable pension incomes for decades. Inflation indexation is seen as a 'vested interest'. However, two recent developments have generated a crisis within pension funds: for the first time in history so many pension funds did not index their pensions and even more importantly, some accrued benefits had to be cut. This is the result of the declining surplus ratio to levels below the minimum requirement of 105 per cent.

Why did this happen? Collective defined benefit funds have pension assets and (future) pension liabilities. The ratio of the two is the surplus ratio, which is governed by the pension fund management board, but monitored by the pension sector regulator: the Dutch central bank. First, a collective agreement between all stakeholders determined to change the discount rate of the liabilities shifting from a fixed discount rate of 4 per cent to a more market-based valuation (the newest agreement is highly complex). Interest rates subsequently declined to one of the lowest points in centuries, so the discounted liabilities rose even further. The value of the assets, of which currently 57 per cent is invested in fixed income instruments, increased too, but by much less. A declining surplus ratio is the consequence.

Second, the surplus ratio also declined as a result of disappointing investment returns. The global financial crisis had a major impact on the riskier investment categories like equities and commodities. And third, average life expectancy is increasing. People live longer, so the pension fund needs to pay benefits for a longer time.

An intense debate about the justifiability of these cuts has ensued. We can already see intergenerational stress on the increase; young people argue that baby boomers have simply paid too little for their pension and some actuaries have made calculations suggesting that young people are indeed overpaying. On the other hand, the elderly are arguing their case, based upon their huge contribution to the reconstruction of post-war society and living through some of the toughest of politico-economic times in Europe in the twentieth century.

Support for the current system is waning. The system is at risk. More and more people are advocating a move to individual defined contribution systems. Strictly taken, the newest proposal (nFTK) is a defined contribution system in disguise.

The new market-based approach for liabilities is the step in my view, but the newest proposal is far too complex. The best things in life are simple. I see three potential improvements. First, investment policies should focus on a long-term horizon. Second, higher returns will be primarily generated in areas of growth, so more assets should be allocated to developing markets. Third, regulators should place greater emphasis on corporate governance and decision processes of pension funds.

So first, pension funds are the traditional long-term institutional investors. The typical investment policy statement has a long-term horizon, potentially infinite. Liquidity requirements of most funds are low and the board of a healthy fund is mostly concerned about generating a sufficient return to exceed the discount rate plus inflation plus costs. So there are good reasons to let the long term rule investment policy. Some investors even say that investing for the long run is easier than for the short run. Statistical analysis shows that risk decreases when the investment horizon increases.

An investment process with long-term goals (and a rigorous investment process) makes it easier for the management team to cope with adverse conditions and behavioural biases. For example, a long-term investor may be inclined to decrease allocations to risky investment if the surplus ratio is 150 per cent to lock in the gains. Current mandates, however, work the other way around. The Dutch pension funds are in bad shape: they have low surpluses. So, the ability to add risk is low. Due to complex and new regulations, risk aversion is the default option, so pension fund management will decrease allocation to risky investments. Lower risk, means lower returns. A 'catch-22' situation is the consequence.

A focus on the long run also relaxes the short-term stress for the surplus ratio. Declining yields push liabilities up. A low or even negative real bond yield, as we are currently experiencing, is typically a temporary phenomenon. If it is temporary, management need not worry a lot. Even in Japan, where bond yields are very low, the real yield has been significantly positive.

Another advantage of a focus on the long term is the acceptance of more risk within mandates. Value investing is a proven investment style for the long run, but it usually does not fit in the mandate of a pension fund because tracking errors are too high.

Second, ageing pension funds need to look for higher returns in developing countries. Aging will have a substantial impact on economic growth and investment returns. The demographic dividend turns into a demographic discount. Lower growth affects investment returns, because it means lower bond yields and lower earnings growth. When the average age of pension fund participants rises, the ability to take risk decreases. Many developing countries have rising productivity and population growth, the required mix for high investment returns. In some cases returns are only higher because of substantially higher risk, but there is a selection of countries which have the conditions to make some serious improvements. As an example, some developing countries like Turkey and Brazil have similar credit ratings to developed countries like Ireland and Italy. Careful selection of those countries is needed, but when they succeed our retirees benefit from high returns, while the developing countries get our investments. It's a win-win.

Third, the regulators should focus on corporate governance and decision processes. The crisis has started a wave of new rules and regulations for Dutch pension funds. The aim of these rules is of course to protect the participants in the pension funds. Management of pension funds has become increasingly complex. To avoid 'official warnings' or negative consequences for stakeholders (pension income cuts, premium increases), investment policy is focusing on a risk aversion attitude. No one can be blamed for taking too little risk. Complexity requires expertise, which is scarce. So the regulator is steering towards consolidation in the sector. There should be fewer pension funds, and they should be bigger. Larger organisations do not necessarily perform better. Decisions may be driven by political arguments or consensus. Size is not the solution. Complex regulation is helping nobody. It gives a false sense of security, but at a potential high price: more expensive pensions.

The solution for the regulator, in my view, is a shift in focus to things that drive organisational success: corporate governance, quality of decisions and culture. Focus on questions like: is the decision-making structure well established? Are trustees taking their role seriously? Are costs justified by the returns? CFA Institute Research Foundation has written a concise document for pension fund trustees, *Primer for investment trustees*, which is a good guideline for most pension funds. With regard to culture, I think that managements should grow in professionalism. Expertise is not equal to professionalism. Professionalism is an attitude. Very recently, the regulator stressed the importance of strong governance, but I think it should be of pivotal importance.

> "Support for the current system is waning. The system is at risk. More and more people are advocating a move to individual defined contribution systems. Strictly taken, the newest proposal (nFTK) is a defined contribution system in disguise"

To fix the current crisis, the Dutch pension fund sector needs enhancements. The focus on a long-term horizon should be embedded in the investment policy. To counter the problem of aging, investing in developing countries may provide a solution to the low yield environment we are currently in. Lastly, the regulator should focus on good corporate governance, quality of decisions and culture.

Written by Rogier van Aart, CFA, Boardmember Education, CFA Society Netherlands

Continuing to lead the way?

The Dutch pension system is undergoing some major reforms. Ilonka Oudenampsen discusses what might be expected from the new financial framework

In every survey of the world's best pension systems, the Netherlands is always somewhere in the top three. However, despite many other countries perhaps looking to the Netherlands with envy, its pension system has had some major blows, mainly since the 2008 crisis, and reform is badly needed. But what are the changes proposed and where might the system be headed?

In June 2011, the previous Dutch government signed a pension contract arranging that, in future, employers and unions will be able to decide for each pension fund what the best balance is between investment risk and being able to give guarantees about the value of the pension.

Since the fall of the government in spring 2012, the new government is tasked with filling in the details of the new contract. A nominal framework and a real framework have been proposed. The Ministry of Social Affairs has launched a consultation to receive feedback and ideas from the pension industry, which closes at the beginning of September.

However, with the process of agreeing on a new financial framework (FTK) taking its time, pension funds are holding off any major changes. This is creating insecurity amongst their members, as there is not yet any clarity on what is to be expected in future.

Although there is a case for a speedy decision-making process to provide clarity, Cardano CEO Theo Kocken points out it is important to ensure the right choice is being made. "We're talking about hundreds of billions of euros here," he says, "so if people believe there is a mistake in the plans, that we might regret this later, then it's better to ensure they don't make that mistake. Some people say that, if you wait much longer [to introduce the new framework], the trust in the pension industry will disappear. They have a point, but if you do it too quickly and make a grave mistake, then the trust will be gone for the next couple of decades."

While the industry is waiting for the new regulations to be finalised, pension funds are already preparing themselves for what might lie ahead. Towers Watson senior investment consultant Sander Gerritsen explains: "Pension funds are at least looking at understanding what the different frameworks are going to look like, what the impact of those frameworks would be on the arrangement they have now and how the future arrangement should then be shaped. So they are definitely preparing, which both the Pension Federation as well as the regulator have urged them to do, to start thinking about this at an early stage."

There are several main issues when it comes to the introduction of the new framework, including what the final regulation is going to look like, how it can be communicated to members, and what the effect will be on pension schemes' investment strategies.

The current proposals consist of two different financial frameworks, between which employers and unions will choose for each different pension fund. The first option (FTK1) is nominal, which is similar to the current financial framework, but with somewhat stricter requirements for a fund's risk profile.

ING Investment Management managing director integrated client solutions Philip Jan Looijen says that in the nominal framework, the average pension fund would invest a bit more carefully. "This probably means they can give less indexation. For members this would mean an increase in security, but less retirement income."

The second option (FTK2) is a real framework, which would allow the pension fund to take more risk, with less security for the member but

with the possibility of a higher retirement income.

However, the consultation document also mentions a third possible framework, one that might be called a combination contract, which sits in between FTK1 and FTK2.

"That combination contract has a prominent place in the consultation document, so I think they are planning to build on this in some way. This [middle ground solution] was also an urgent request from the Pension Federation and some of the big pension funds," Gerritsen explains.

Kocken adds: "Most people believe that you should be able to take more risk with part of your portfolio, but that you should also be able to convert part of it to give some guarantees about future retirement incomes. Over a member's lifespan, this needs to become more secure and there are possibilities for that. So that means - and I have good hopes for this - that instead of those two extreme varieties [FTK 1 and FTK2] which have been proposed now, we will find a happy medium."

Part of the discussion is also what will happen to the recently introduced Ultimate Forward Rate (UFR). Used for the first time in September 2012, the UFR now provides pension schemes with two different ways of discounting their liabilities and therefore two different coverage ratios.

Kocken firmly believes the UFR should never have been introduced. "De Nederlandsche Bank (DNB) was only allowed to work with the discount rate on one side of the balance sheet and not with the coverage ratio as a whole. The current proposals speak about using the average coverage ratio, which is much fairer. At the moment, if the interest rate goes up, the income on bonds goes down. But because the average interest rate decreases, the liabilities go up, so your coverage ratio goes in the wrong direction twice."

It has been suggested in the proposals that the average coverage ratio should be used, based on a 12-month period. This would take both the average of the returns on assets and the average of the liabilities over that period, unlike the current UFR, which only looks at the liabilities over a three-month period.

FTK2 also has an interest rate curve, but for this one schemes can deduct the inflation, based on the ECB's guidelines, which is 2 per cent, and are able to add 1.5 per cent risk. In this framework the liabilities increase slightly and therefore the coverage ratio decreases. However, in exchange for that the pension fund is allowed to be more flexible with its risk profile. And all setbacks and windfalls can be spread out over a 10-year period.

Looijen adds: "You hear a lot is pension funds saying that FTK1 is too strict and that FTK2 sounds better in terms of flexibility, but it is a dramatic contract in terms of communication and administration, due to this 10-year spread."

The complexity the two different discount rates creates is only one of the many things that pension schemes have to communicate to their membership. Mainly during the past few years, members' trust in pension funds has decreased sharply, especially after the benefit and rights cuts that have been announced over the past year.

Despite this being unwelcome news for both members and trustee boards, it has increased trustees' focus on the need for good communication. And while discussing and reviewing the new financial frameworks, trustees now also ask how they will explain the changes to their membership.

"In the eyes of the public, pension funds have fooled the world by promising a solid pension, a promise which is now clearly broken. Before they start making other plans, I think there will be a lot of attention on communication, much more so than in the past. So whatever they do, they will have to communicate it much better. But if you look at what is ahead for the sector, I wonder how this difficult matter, where even experts sometimes need to read three times to understand it, how that can be communicated to members who have never been very interested in pensions in the first place," SEI Institutional Group managing director sales Netherlands Peter in de Rijp says.

"I'm not saying the new framework won't be good, but I do wonder how you get such a message across to such sceptical members. The pension fund used to have a lot of public trust, people found it complicated what was going on, but they assumed everything was managed properly. That is now gone. And if you then need to translate such complex messages in easy terms, then that's a very difficult task."

The investment side is also likely to be affected by the change to a new framework. Currently the regulator DNB keeps an eye on schemes' risk profile and, for underfunded schemes, on their recovery plan, requiring them to take on less risk than they might want to.

However, in order to give harder guarantees to eventual retirement outcomes in FTK1, a pension fund would have a different risk profile and would probably be required to take less risk. On the contrary, in the FTK2, with its softer rights, pension funds will be able to take more risks than they are at present.

Gerritsen notes: "Under the nominal contract pension funds might invest a bit more defensively or they might use some protection structures on a strategic level. In other words, as soon as stress occurs on the market, a bottom for the decline of the coverage ratio is created by means of something such as an option strategy. But of course that needs to be done well-analysed and cost efficient."

He adds that DNB will require that trustee boards can better show that their risk profile fits the nominal contract they are offering. There will be more emphasis on analysis and monitoring the risks. Based on that, trustee boards might be forced to build some protection into their investment strategy and move towards less risky investments.

"The real contract requires less security and therefore there may be more possibilities to invest in equities to eventually be able to realise that indexation ambition. And because you can spread out the risks over generations by using a smoothing mechanism, the real contract is more designed to accommodate volatility in financial markets" Gerritsen says.

However, Looijen adds that it is not a given that many pension funds will rigorously change their investment strategy. "If a pension fund has a current policy that fits their ambition, that is not curtailed by the regulator and that won't see any extra requirements under FTK1 or FTK2, then there is no reason to change your policy. But for a pension fund who would like to take some more risk, but is not allowed to because they are in a recovery plan, then it is interesting to see if the situation would be different under the new frameworks."

WRITTEN BY ILONKA OUDENAMPSEN

A strong voice

Laura Blows speaks to Christian Dargnat, the new president of the European Fund and Asset Management Association (Efama) about highlighting the important role asset management plays in society and how it needs to develop

Q: How are you finding your new role as president of Efama?

A: While the role is new, I have been working as vice president of Efama for the last two years. I think it is an exciting time to take on this role as there are currently many challenges and many opportunities to embrace. We have a key role to play within finance and the whole economy.

Q: What opportunities do you expect to have in this role?

A: I would identify two main opportunities here.

Today, more than ever, Europe is looking for growth. If you want to grow, you need to invest. If you want to invest, you need some capital. If you want capital, you need to have savings. And that is exactly where we are. We are altogether collecting assets and savings and I think in this environment we need to look at long-term investment.

On the one hand, companies are calling for sustainable, long-term financing and we are ideally placed to offer this. The asset management industry is in a position to find alternative ways of financing this gap on the side of the bank model.

On the other hand, European citizens are looking for long-term, robust, transparent, diversified and cost efficient solutions to prepare for their future. Our client-centric business model takes fully into account that for our future retirement we need to rely on ourselves more rather than on the state.

We are the main link between the corporates and the investors, both of which offer strategic opportunities on both sides.

Q: What is Efama currently focusing on?

A: As we are part of the solution not part of the problem, our first focus is to innovate for the benefit of the economy.

The Ucits international recognition demonstrates the European capacity to succeed. Efama represents the industry of the long-term investor and is launching various initiatives in this way.

We are working closely with the European Commission towards building an Officially Certified European Retirement Plan (Ocerp with unified standards across Europe. Although we are only at the beginning of this process, I see this as an important step as we are always striving to create solutions that are of benefit to all European investors.

The initiative is interesting from a long-term investing point of view, considering an individual has the ability to pay into a pension across Europe. I think we should take the opportunity to work together with the regulator to try to effectively create a framework that allows an individual to invest in a pension regardless of where they are based or how many different countries they work in without being affected in any way. I think it will align the framework across Europe and I think it will be an interesting focus for us as it will boost our industry, our capacity to innovate, and will improve our competitiveness.

Another goal of ours is highlighting ESG investment. When we talk about long-term investment you need to take into account the extra financial criteria, such as ESG issues. Our prime responsibility is to invest in the best long-term needs of our beneficiaries. We live in an increasingly interdependent world facing social, governance and environmental challenges that can undermine the performance of our investments. Indeed, there are opportunities to identify risk through focusing on

Efama president Christian Dargnat

In June 2013 Christian Dargnat was elected president of Efama for a two-year term, having been vice president since June 2011.

Christian has acted as chief executive officer of BNP Paribas Asset Management and as CIO of BNP Paribas Investment Partners since 2009. He joined BNP Paribas Asset Management in 2006 as chief investment officer and as a member of the Executive Committee. Before that, Christian held several senior leadership positions including head of balanced management and strategy and head of equity and balanced management / head of convertible bond and arbitrage products in the asset management division of Crédit Agricole.

In September 2010, he was appointed chairman of the MEDEF committee 'Currencies and International monetary system'. Since 2008, he has lectured at Hautes Etudes Commerciales. He graduated with a master's degree in economics and finance from the University of Paris Dauphine in 1988.

ESG, so I think if you want to outperform, within a long-term horizon, you need to integrate the ESG criteria. Acting like this, we will protect and enhance our investment returns as well as defend the interests of our clients.

Our second focus is to ensure a strong voice across the industry.

We have to make the client and the regulators aware that in the past few years we have faced an unprecedented rate of regulation. We would like to take a break from this and find some synergy of the rules and regulatory moves. I think we should assess both the new and old changes that have taken place across the industry, and most importantly, analyse what impact these have had on our clients. Some will have had an excellent result, some not. We need to take a step back and acknowledge these changes.

At present, the asset management industry suffers from a lack of a level playing field. I'm talking about our situation with respect to other financial products. I am very happy to see that regulators are focusing on asset management for more transparency, but I would like to be sure that we are treated on the same level with respect to the pensions industry and the insurance industry.

> "We live in an increasingly interdependent world facing social, governance and environmental challenges that can undermine the performance of our investments"

Another important focus is Packaged Retail Investment Products (Prips) and how we as an asset management industry consider their implementation. The European Commission is seeking ways to provide the same investor protection to these retail investors independent of the legal form of the product or the sales channel. The European Commission is pursuing this aim through the Prips Initiative. To me it should be a clean sheet and should be fixed, as if not it will create problems for certain citizens.

Q: How are you addressing these aims?

A: We try to address these goals through the conversations we have with the European Commission. For example, with a long-term investment fund it could be opportunistic to say 'why shouldn't we integrate some ESG criteria in this project' or 'how do we further take into account the retail investors needs'? We try to differentiate asset management products, compared to an insurance product for example, and this is a way to do so. This is a conversation to not only have with the European Commission, but also when we are speaking with our own clients.

It was true before my presidency and it will be true after my presidency that we all need to take great care when it comes to our clients. It is in our best interests to safeguard them. Without investor trust, we cannot hope to attract their savings and increase assets under management. We need to first convince regulators and politicians that we have a real added value and that our interests are aligned to that of our clients. We can best achieve this through education of all parties.

We have to try and convince clients that by using ESG criteria we are helping to solve their problems. We are not always on the same page with this argument so we have to work with our clients, but also regulators and politicians. Very often there are decisions made to protect the interests of our clients and we welcome the initiative but we do feel that we are part of the solution and not part of the problem. To me, the regulators are, at times, trying to get rid of a problem that doesn't exist in asset management. We need to remind them that they need to consider us and we consider them in partnership in favour of the client.

Q: That seems to imply that there is a problem with trust for the asset management industry. Is that the biggest problem the industry needs to tackle?

A: It can be considered a big

“We have to make the client and the regulators aware that in the past few years we have faced an unprecedented rate of regulation. We would like to take a break from this and find some synergy of the rules and regulatory moves”

challenge. Having the trust of our clients is the most important thing and is something we are always working on. I’m not sure if our clients have distrust. It’s more that we need to explain what we do, who we are and we need to be much more energetic in the way we present our products. Education is key. So I do think it is a challenge but we need to take a long-term education view - starting with the younger generation - to explain who we are and what we do and why investment savings are required. Through the media, we need to make people aware that we are an industry that is helping to allocate savings in an efficient way to finance corporates and to finance pensions. Our interests are aligned with clients and we really need to work on this credibility aspect. For example, one of the biggest successes of the financial industry in the last 25 years is the Ucits framework. Twenty-five years ago this framework was created and now we are able to demonstrate that all across Europe we have a framework that is not only considered credible, but has also been a great success. So we should be proud of what we have done and what we are going to continue to do. After 20-30 years we have a product that is considered the pinnacle of investor protection so let’s enjoy its success and continue to work in that direction.

Q: What trends are you seeing from institutional investors?

A: If you look from a geographic point of view you will see that there is a difference between emerging markets, where the rate of growth is around 10 per cent, compared to the developed market, where the rate of growth is around 5 per cent. We need to keep in mind that we are in an industry that continues to grow. We see this growth in products such as ETF trackers. We need products that are dedicated to absolute returns. We need products that are very good at getting their asset return, that are welcomed by the client. There is still a category of products that are used as a possible alternative to ‘traditional’ investments that are becoming more well-known. We have institutional friends asking us to combine different strategies to provide them with a bespoke product. This will continue to grow across the world and all across the institutional segment. This is the direction that we are going in today and this will continue. The shift from defined benefit to defined contribution is a good example of this. This is key and it will impact the solutions available. We are predictably concerned about the growth of loans products. All across Europe many companies and clients are asking us to create loans products to fund SMEs. In some parts of Europe there has been strong growth of SRI products. SRI as an approach is currently niche, but there will come a time when you have to integrate SRI criteria in your portfolio management, although this will probably take a few years.

Q: What are you hoping to achieve during your term as president?

A: To maintain and to reinforce Efama as a strong industry body, and for it to continue being considered as a key voice of the industry. To be able to deliver valuable solutions to assist long-term investment and thirdly, to be recognised as an industry that adds value to the economy.

WRITTEN BY LAURA BLOWS

European Fund and Asset Management Association (Efama)

Efama is the representative association for the European investment management industry. Efama represents through its 27 member associations and 60 corporate members about €15 trillion in assets under management of which €9.4 trillion managed by over 54,000 investment funds at end March 2013. Just over 35,500 of these funds were Ucits (Undertakings for Collective Investments in Transferable Securities) funds. The association was founded in 1974 under the name ‘European Federation of Investment Funds and Companies’.

A different look

Peter Davy explains the reasoning behind France's unique approach to pension reform

The economy might be looking up, but as French President François Hollande faces la rentrée after the summer break, he faces some old problems and principle among them is pension reform *(see page 4)*.

The protests were booked even before the details of proposals for reform were clear. Prime Minister Jean-Marc Ayrault met with unions and employer representatives in the last week of August; CGT, the country's second biggest union and a key player in protests over reform back in 2010, had street demonstrations scheduled for 10 September. The Force Ouvrière trade union is also opposed. Leader Jean-Claude Mailly warned in a recent interview with Le Figaro that pensions would be the biggest source of contention in the next six months.

"Tension with the government is inevitable," he said.

Whether the reforms warrant such opposition, however, is open to question.

A poor start

Certainly Hollande is not the most obvious target for union anger over pensions. Last year, he partially reversed the reforms that prompted such bitter protest in 2010 – restoring a retirement age of 60 for those who started working early in life, mothers with at least three children and the older unemployed – at a cost of €3 billion a year by 2017.

That surprised those in other countries, where governments have been pressing ahead with rising retirement ages to tackle increasing longevity.

"Shifting back the state pension age was quite astonishing, given the pressures on the French economy and society and when every other nation is pushing forward," says international law firm SJ Berwin pensions partner Wyn Derbyshire.

The present reforms, aimed at tackling state pensions deficits forecast to reach €20 billion by the end of the decade, will represent a shift in the right direction, but they are still likely to be limited in scope.

As early as June, with negotiations barely underway, Hollande ruled out a rise in the retirement age from 62, and indicated he would not tackle the preferential treatment enjoyed by public sector pensioners. His preferred approach – to increase the paying-in period to qualify for a full state pension to 41.5 years – is likely to be introduced only gradually from 2020 or 2025. In the meantime, it looks like the sole contributor to narrowing the deficit will be increases in the taxes on companies, despite the EU Commission's calls in May to tackle the pensions deficit without putting additional burdens on French employers, who were already struggling to remain competitive.

At economic consultants Asterès, director Nicolas Bouzou says France is now trailing almost everywhere in Europe, when it comes to reform.

"The German and Scandinavian countries made reforms to pensions, the labour market and education before the 2008 crisis; the Southern European countries, notably Spain and Portugal, have made reforms because of their sovereign crisis; France has not," he says.

"Hollande is not a reformer," he adds.

Little by litte

In fact, this might be a bit unfair – if not to Hollande, then to France.

Despite often being lumped together with other continental countries facing severe problems in their economies and retirement

“The French have the lowest pension age on paper in Europe but it is just the earliest figure at which you can get a pension. It doesn’t mean you get the full pension at that age”

systems, France is better off than many, according to the LSE’s Centre for Analysis of Social Exclusion, visiting research fellow, Aaron George Grech.

That’s partly down to demographics: birth rates in France are about 20 per cent higher than in Germany. On EU figures, Germany’s population will decline by 15 million by 2060; France’s will grow by nine million. Nor is the French pensions system that generous. Much, for example, has been made of low retirement ages in France, but that ignores the penalties involved.

“The French have the lowest pension age on paper in Europe but it is just the earliest figure at which you can get a pension. It doesn’t mean you get the full pension at that age.” In fact, both men and women in France can retire at 60, but have to wait until age 65 for a full pension, rising to 67 by 2018. The average pension is 60 percent of post-tax income, against a 69 percent average for industrialised countries.

The intermittent strikes and protests over pensions, not just in 2010 but earlier in the previous decade during reforms under minister of social affairs François Fillon, have not been entirely without cause.

“People always ignore how much France has reformed,” says Grech. Back in 2001, he points out, when the European Commission began its forecasts of pension spending as a proportion of GDP, French expenditure was expected to increase by 3.6 per cent by 2040 Today, it’s 0.5 per cent by 2060, against a 1.5 per cent European average and 2.6 per cent in Germany.

“It really has done a lot to adjust the system.”

So why the European Commission’s dire warnings in May? It called for “urgently needed” policies, with commissioner for economic and monetary affairs Olli Rehn even hinting the Commission might use new EU powers, including fines, to compel reform.

Partly it’s a proxy for concerns about the French economy generally, suggests Grech. Although the country emerged from recession to grow 0.5 per cent in the second quarter, the economy faces significant challenges, including unemployment that hit a new record of 11 per cent in June and is expected by the International Monetary Fund to increase to 11.6 percent next year.

It also does face that significant pensions deficit of €20 billion in 2020, while the proposed reforms’ aim to tackle about €7 billion, which is the part of the estimated deficit in the general regime only (with France also having a number of complementary schemes in different industries). Even that might be too hopeful.

"The deficit numbers are probably an underestimate because they are based on optimistic assumptions in terms of underlying economic growth and unemployment rates," says OECD senior economist and head of the French desk Hervé Boulhol.

Added to that, pensions spending in France remains significantly higher than elsewhere: over 13 per cent of the GDP in 2011, against 7-8 per cent in the UK, and accounting for 26 per cent of the total public expenditure for the same year, against less than 16 per cent in the UK. And despite this, it provides wildly different outcomes, with the complexity ensuring some workers, such as those in the public sector, do much better than others.

This, again, explains some of the continuing calls for reform. The OECD, for example, would like to see a universal pension scheme – "systemic reform that would not only increase transparency but would be fairer and enable labour market mobility between public and private sectors", says Boulhol.

"It is not just about budgets."

Plus ça change...

This kind of systematic reform, however, will certainly not result from the current proposals – no matter what happens in the weeks ahead.

According to the University of Reims' Anne Reimat the financial crisis has had a "catalytic effect" in France, highlighting weaknesses of the pension system. But, despite this, proposals on the table are "parametric" – just as earlier reforms.

"They don't change the structural functioning of the whole system – mainly public, financed through mandatory social contributions and pay-as-you-go, based on the employment status; they only change the level of social contribution, the age of retirement, the length of the career necessary to obtain a full pension, and so on," she explains.

No structural changes seen elsewhere, such as the introduction of notional accounts or big increases in the share of private funded pensions, which account for less than 4 per cent of the value of French pensions, are likely.

"Indeed, despite the difficulties, there is still a consensus to maintain the current system in this state, or, more exactly, a consensus that the political and economic costs of changing the system seem too high," says Reimat.

Given that, it's hard to disagree with the unions on one thing at least: pensions will remain a source of contention in France for some time to come.

WRITTEN BY PETER DAVY, A FREELANCE JOURNALIST

Changing appetites

It's not just the public sector that is better placed than some might expect when it comes to pensions: the few private sector pension schemes there are in France enjoy at least some advantages over those elsewhere.

On the one hand, the insurance companies that dominate French institutional investment have high allocations to fixed income – up to 75 per cent of long term investments, according to market researchers Image & Finance's annual research covering the institutional market. On the other, liability driven investment has not caught hold among French pension funds as it has elsewhere, according to AXA Investment Managers head of European pension solutions Erwan Boscher.

"That's the big difference, because the regulation does not require the same mark to market approach," he explains. The result is that schemes are not tied to high allocations to domestic bonds.

Despite this, challenging markets have brought a response form pension investors. Boscher says there is much more international diversification.

Fidelity's head of the institutional business for France, Jean-Marc Didier, agrees, and says it's not just geographic diversification that's been seen.

"It's probably not very original in the current environment, but the main trend is the search for yield," he says. Investors have been increasingly interested in credit and high yield, both European and US. And the volatility in May and June did not put them off.

"We saw additional inflows in July; people already invested in high yield basically profited from that spread widening to increase their investment."

And while there's been increasing interest in US equities, there's little sign yet of any great rotation from bonds to equities. There is one sign of nervousness, though: a pick-up in interest around global inflation linked products.

"They want some protection against inflation, because at some point in the future all the liquidity being pumped into the system will probably reach the real economy, both in the US and in Europe."

Collective DC – in it together

As the UK toys with the idea of collective DC, Adam Bernstein explores the lessons learnt from previous countries' implementation

It's often said that there's safety in numbers, yet individuals are still very territorial in many aspects of their lives, especially so when it comes to financial matters and in particular, their pension. However, this may be working against their interests.

With rising levels of dissatisfaction over pension returns, one solution, a shared risk model known as Collective Defined Contribution schemes (CDC), is making waves in several countries around the globe and it's being mooted again in the UK. But will it ever be implemented and what could the UK learn from those countries where it's part of the financial landscape?

Background

With falling annuity rates in the UK for more than 20 years, the pensions market is having a tough time pleasing anyone. According to William Burrows Annuities, in October 1990 the annuity rate was 16 per cent, but by August 2013 the rate had dropped to around 5.6 per cent.

A report from RSA, *Collective Pensions In The UK*, published in June 2012, found that the UK investment system "...is not fit-for-purpose. Pension saving in particular was high-cost, poorly structured and patchy." This, and the abandonment en masse of the defined benefit scheme, meant members have become disenchanted with pension options in the UK.

The UK's Pensions Minister, Steve Webb, is heavily behind CDC. In July 2012, he laid down a challenge that demanded that future pension provision had to provide members with more certainty as to their future pension income, saying: "Now is the time for the pensions industry to look at the market gap in relation to affordable guarantees and provide the products consumers are seeking."

Destination UK?

So is UK pension provision going to change? Aon Hewitt senior partner Kevin Wesbroom considers that with Webb driving CDC forward it is likely to be implemented in the UK: "The Department for Work and Pensions (DWP) were the blockers before [when the idea came up years earlier under a Labour government] and they have now been overruled by Steve Webb. Labour generally supports CDC as a concept."

Barnett Waddingham practice area leader in trustee consulting Danny Wilding thinks along similar lines to Wesbroom. Although he doesn't think CDC is likely – yet - "it does look as if it will now get proper consideration under Steve Webb, and so CDC has a good chance".

Buck Consultants head of pensions policy Kevin LeGrand is firmer in his expectations. He says that the UK's last Labour government looked at a narrower range of options than the coalition government and Webb has made CDC his personal initiative. "He [Webb] appears in principle to have brought into the concept of the need for legislation to be non-intrusive and

> "There are many obstacles on the legal and regulatory side, but these are not insurmountable. What may be more difficult is persuading employers and the UK public that CDC is a good idea"

non-prescriptive… and I expect it to be included as a one of the specific options to appear in the second *Reinvigoration of Workplace Pensions* paper."

Sitting in the middle, Sackers solicitor in the investment unit Tom Jackman thinks that the call is harder to make: "There are many obstacles on the legal and regulatory side, but these are not insurmountable. What may be more difficult is persuading employers and the UK public that CDC is a good idea. My personal view is that it is unlikely that we will see a direct copy of the Dutch system, but the UK government may try to draw elements from it in designing our own system."

Robeco director of European Pensions Jacqueline Lommen agrees with Jackman's point and says that it's the common links that the UK and Dutch (and Irish) occupational pension markets have that could make CDC work. "One of the common characteristics of the UK and Dutch market is the traditional reliance on DB schemes. This is in sharp contrast to the other 27 countries in the region that since the early days have opted for DC schemes or variances."

Benefits

There are several benefits to CDC and Wesbroom notes them as including a "higher, more stable pension". He also says that under CDC there's "no need to involve members in investment decisions – experience with DC suggest that members do not want to take investment decisions, and are generally ill-prepared to do so". He also notes that there would be no need to buy annuities when rates are low.

Wilding considers the main benefit to be "a fairer sharing of the pension outcomes between members compared to pure DC". He sees a smoothing effect with winners and losers, where overall everyone benefits from the size of the scheme. He expands: "CDC should ensure a fairer distribution, meaning those who retire when market values are low and/or annuities expensive will benefit the most, but economies of scale, particularly for investment costs and reducing the incidence of annuity costs, should also mean a small advantage for everyone in larger arrangements."

Jackman also believes that risk-sharing and economies of scale should produce better retirement outcomes for members: "The government actuary's department has done some interesting modelling on this, but the assumptions underlying them have been criticised by some."

This view is shared by LeGrand, who also sees better returns through collective risk: "By pooling all members' assets they can be held in riskier funds for longer than would be recommended for an individual member who has to start to de-risk their portfolio on the approach to retirement date."

The RSA report cites differences in return that can be achieved: "If a typical Dutch and British person save the same amount for their pension, retire on the same day and die at the same age, the Dutch person can expect a 50 per cent higher income in retirement." The report authors attribute this mainly to the collective nature of pension saving.

Around the world

CDC has been successfully implemented in other countries, notably Denmark and the Netherlands. However, it's not all been a bed of roses. Wesbroom mentions that the Netherlands is "currently reducing pensions payments to keep the scheme costs constant" *(see page 20)*. That said, he's to keen point out that it's an extraordinarily bad time to be buying annuities right now. Even so, LeGrand thinks that reducing pension payments because of poor performance is hard to enforce as the pension "might be the only income a pensioner has, with no opportunity to make it up".

Jackman also sees this problem: "If [the UK] follows the Dutch model… it'll entail the possibility that indexation could be withheld. Member contributions could also vary." He goes on to say that in more extreme circumstances, pensions in payment could be cut. But the expected outcomes would still be better for members compared with the 'pure' DC arrangements that most private sector employees are offered at the moment. He also says that the Dutch have found that the distribution of risk between younger and older employees has been controversial: "Younger members are aggrieved at effectively subsidising older members because of the way that the risk sharing works out."

Lommen notes pension complexity as an issue and an increasing number of Dutch market practitioners are implementing a less complex and more transparent solution - so called 'smart DC' schemes. "This is more in line with international practices and is already a tested concept in the Netherlands. The smart DC schemes rely on the usual economies of scale and low institutional tariffs. The risks are shared collectively and re-insured via insurance companies. The financial risks are born individually, though."

For Wilding, a key lesson from other implementations is clear member communication: "Members need to understand what collective DC is, and what it is not - in particular that target benefits are not guaranteed."

UK success?

For Wesbroom, the key to success of CDC in the UK is to find a way to stop governments from tinkering with the system: "These are the two big concerns that employers have. Will the government change the rules and make a CDC scheme into a defined benefit scheme at some later stage? And how do I explain 'soft guarantees' [of returns] to members – will this be a mis-selling scandal in years to come?"

Lommen notes this point. She talks of the laissez faire experience in the Netherlands where "the legislators do not intervene in the design of pension schemes. Employers and employees decide amongst themselves on the design of the pension promise". She continues: "The government ensures that the providers of the financial and biometric risk cover have sufficient means to back up their promises made to scheme members."

Another part of the jigsaw involves selling the scheme to members and Wesbroom thinks that this revolves around persuading them that professionals are better at looking after their pension.

But what of the traditional annuity? The success of CDC could mean the end to the traditional annuity says Wesbroom. "Members would not have to buy annuities at the 'wrong time' in the interest rate cycle." But contrary to this, Wilding thinks that the traditional annuity would still have its place for early leavers converting to DC, or those with small benefits at retirement where drawdown is not practical, and possibly for older pensioners in any case.

Jackman thinks that the insurance market would devise [annuity] products that would work with CDC. Furthermore, if the risks are shared only among those members who have not yet retired, traditional annuities could still be used at the point of retirement.

LeGrand isn't so sure that CDC needs selling to investors if the scheme is chosen as the automatic enrolment scheme offered by an employer – "employees would be enrolled and would have to opt out if they didn't want to be members. Of the rest there is essentially no difference from selling a plain DC scheme; the outcomes cannot be guaranteed."

Wilding believes that the UK system needs to change. "Regulation is needed to allow collective funds to operate (so that they are not allocated to individuals until benefits crystallise), and to allow income drawdown from a collective fund for pensioners." He also thinks that CDC is not a small-scale project as a critical mass of members is needed – "the administrative costs would be prohibitive for small employers unless they group together".

Jackman agrees to an extent and he sees four areas in need of change - altering the regulatory framework to facilitate CDC; incentivising employers to offer CDC; educating the workforce of the benefits to mitigate potential causes of dissatis-faction; and considering compulsion as risk sharing and economies of scale rely on a high volume of members and mass opt-outs at any stage is likely to cause problems. For him, the key questions revolve around "how valuations are carried out and their impact on conditional indexation, member contri-bution rates and (in extreme circum-stances) reduction of benefits".

The mechanism for distributing funds between members needs to be clearly set out, says LeGrand, so that members can understand what they are agreeing to, and then the process has to be transparent in its application. "Without that transparency, members may become suspicious, especially if the outcome for them is less than their expectations."

The final word goes to Jackman. He thinks that CDC offers a simple message: "Although nothing is guaranteed, CDC is likely to provide them with a better and more predictable financial outcome than an individual DC arrangement."

WRITTEN BY ADAM BERNSTEIN,
A FREELANCE JOURNALIST

Poland eyes reform of pension system

Poland's government has released a report outlining possible reform scenarios of the country's pension system. Meanwhile, local analysts say the proposed measures could prove to be more detrimental than the problems they are designed to tackle, reports Jaroslaw Adamowski

In July 2013, Polish Prime Minister Donald Tusk announced that the year 2013 will be critical for the country's economy, as the public deficit would increase by some 16 billion zloty (€3.84 billion) compared with a year earlier. To avoid the fate of some of the eurozone's most troubled countries, a series of cuts in public spending would need to be implemented to balance the state spending, Tusk said.

Meanwhile, some local analysts say that despite the severe cuts in the budgets of virtually all ministries planned for this year, the austerity measures might not suffice to put the Polish economy back on track.

Private pension contributions rise

Under the current system in Poland, 19.52 per cent of a person's basic salary is allocated to their pension contribution, half of which is covered by the employee and half by their employer. State-run pension fund Social Insurance Institution (ZUS) currently receives a 4.5 per cent share of the basic salary, while a privately-owned open pension fund (OFE) selected by the employee receives a further 2.8 per cent.

As of mid-2013, the 14 OFEs active in the Polish market had over 16.2 million contributors, according to data from the country's Financial Supervision Authority (KNF). Dutch-owned ING OFE has the biggest market share, at 18.79 per cent, followed by the UK's Aviva OFE, with 16.50 per cent, and Poland's PZU OFE Golden Autumn (Złota Jesie), with a 13.74 per cent share.

Since 1999, Poland's private pension funds have amassed about 270 billion zloty (€64.8 billion) in individual contributions, providing them with a significant impact over the country's economy. Their investment portfolios consist of state treasuries in 44.39 per cent, bank deposits and treasuries in 5.17 per cent, and stock in 38.55 per cent, according to figures from KNF.

In 2011, the amount of contributions paid by Poles to OFEs was decreased from 7.3 per cent of their salaries to 2.3 per cent. Two years later, it was increased to 2.8 per cent, and in 2017 it is to be raised to 3.5 per cent. In the same time, the share received by the ZUS is set to decrease to 3.8 per cent in 2017.

Between 2010 and 2013, the average return on investment by OFEs was 16.64 per cent. The best results were posted by German-owned Allianz OFE, at 19.13 per cent, followed by Scandinavian Nordea OFE, at 19.05 per cent, and U.S. Amplico OFE, at 17.98 per cent, according to figures released by the KNF.

However, the looming budget cuts planned by the Polish Ministry of Finance could undermine the funds' performance over the coming years, as the government is looking for ways to plug the leaking state budget. Given their significant assets, private pension funds are a potential target, some local observers say.

Critical report

A joint report released by the Polish Ministry of Finance and the Ministry of Labour and Social Policy in June 2013 blames OFEs for a significant part of Poland's financial woes. According to the report, entitled the *Review of the functioning of the pension system*, if OFEs had been scrapped, the country's public debt would have been 35.2 per cent in 2012, as opposed to 52.7 per cent. The report also claims that the return on investment generated by OFEs was on average at least 0.2 per cent lower than that of state-run ZUS.

Furthermore, while admitting to OFEs' positive role in boosting the Polish stock market, the authors of the publication make a claim that, in the long term, the market's dependency on investments by the private pension funds could become a negative factor.

The report puts forward three recommendations for the Polish government. These include ending compulsory participation in private pension funds; making the participation voluntary; and putting the contribution paid to OFEs on top of the current pension contribution. However, a number of local analysts voiced strong criticism of the report's recommendations.

"The recommendations presented in the review of the functioning of the pension system lead to weakening pension security," says an expert from the Civic Development Forum (FOR) think-tank, Dawid Samo. "In reality, the ZUS and OFEs are cooperating, and not competing against each other.

"The ZUS' valorisation and the rate of return on investment of OFEs are supplementing each other. When one of them is decreasing, the other is increasing, compensating for the losses. Owing to this, pension security is higher," he adds.

In an interview with local business daily *Dziennik Gazeta Prawna*, Polish Minister of Finance Jacek Rostowski said that the scenarios that "cannot be completely ruled out" include "closing OFEs or phasing them out". This would mean that the ZUS could take over the contributions paid by Poles to OFEs.

According to professor Marek Jabłonowski, a political scientist from the University of Warsaw, the reform efforts by the Polish government represent an unprecedented policy shift in Poland.

"Since the launch of the current pension system, there has been a strong consensus by both decision-makers and experts that the bigger the involvement of the private sector in the system, the more secure our pensions are," Jabłonowski says. "However, with the current economic downturn, this consensus has begun to slowly dissolve."

Increased retirement age

This year, the ZUS is projected to distribute close to 181 billion zloty (€43.44 billion) to pensioners, an increase of some 9.5 billion zloty (€2.28 billion) over a year earlier. The planned spending on pensions represents as much as 60 per cent of Poland's planned revenues of 299.4 billion zloty (€71.86 billion) for 2013. It is also one of the main reasons why the Polish government will have to borrow at least 35.6 billion zloty (€8.54 billion) this year.

But perhaps the biggest challenge that local decision makers are yet to face is how to hamper the progressive ageing of the country. In 2011, the number of children per woman in Poland stood at 1.30, according to figures from Eurostat. Only Hungary and Romania has less children per woman among all the EU member states.

To decrease the weight of pensions on Poland's spending, the government decided to gradually rise the retirement age for men and women starting 1 January 2013. Under the plan, the retirement age for both sexes is to reach 67 years, with one month added every four months. Prior to the reform, Polish men retired at 65 years and women at 60 years.

Poles opt for mixed system

Recently published data shows that most Poles want a mixed system with the participation of both the state and privately-owned pension funds. According to an opinion poll ordered by employers' organisation PKPP Lewiatan and conducted by research institute GfK Polonia in July 2013, 70 per cent of those polled say they would feel safer if a part of their future pension was paid by state-owned ZUS. However, only 20 per cent said they would agree to transfer their entire savings from a privately-owned OFE to the ZUS, while 57 per cent would turn down such an offer.

"Many Poles view private funds and financial companies as more reliable than state institutions," Jabłonowski explains. "But after close to a quarter century of life in capitalism, these people have also become mature customers who are risk-averse and aim to find the safest place for their money."

WRITTEN BY JAROSLAW ADAMOWSKI, A FREELANCE JOURNALIST

The search for income

Edmund Tirbutt finds out why, and where, investors are searching for steady income streams

The search for higher income levels from European pension funds during the past three years has had several major drivers, and experts disagree about which has proved most significant.

Many readily attribute the entire shooting match to the fact that the recent financial crisis has resulted in historically low interest rates – 0.25 per cent in the US and 0.5 per cent in the UK and eurozone. This has in turn reduced the returns available from cash and bonds.

Others, however, feel that the trend for defined benefit schemes to close to new members has been just as relevant, because schemes have less new money coming in with which to pay their liabilities. International actuaries and consultants LCP investment partner John Clements actually feels it has been more important.

He says: "Companies often reach a tipping point at which they go from being cashflow positive to cashflow negative, and from then on the trustee's role is central to the shrinking of the fund. It's not necessarily about getting massive amounts of growth but about

"It's not necessarily about getting massive amounts of growth but about controlling the assets to get a lot of income, and many clients will be reaching this tipping point over the next five years"

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AXA Investment Managers head of UK institutional business development Madeline Forrester highlights that this problem can be exacerbated further in industries where technological developments or changes in the business mean that the current workforce is much smaller than that of past generations. She also points out that similar issues are anticipated even in the public sector, where schemes are still open to accrual.

She says: "Many pensions managers believe that they will see increases in opt-out rates as a result of scheme changes, and these same schemes are faced with reductions in the current workforce due to austerity measures and outsourcing. As a consequence the point at which these schemes also become cash flow negative is felt to be materially closer than it once was."

Interest in income has been boosted by the fact that pension fund populations are increasingly ageing, therefore creating a need to achieve a stable yield for longer, and by a focus on obtaining absolute returns through a more active investment approach – within which a higher income plays an important part.

Absolute return funds normally have a broad mandate that enables them to invest in all asset classes. They will look at economic dynamics, valuations, technical inputs and qualitative arguments and act according to which investments are most attractive. Whether income is preferable to growth will vary according to the fund manager's interpretation of the current economic climate and the opportunities available.

Aegon Asset Management senior portfolio manager Robert Jan van der Mark says: "Old asset managers are expanding their product ranges to include not hedge funds but an active alpha strategy that looks away from the standard benchmarks but tries to achieve a lower volatility return. Interest from European pension fund managers in our absolute return funds in the last three years has grown at a faster rate than with any other type of product we do."

Fixed income

With government bonds now yielding 2 to 3 per cent, and high quality investment grade corporate bonds typically only 0.7 to 1 per cent more, European pension fund managers have been demonstrating an increasing interest in high-yielding corporate bonds, where it has been possible to achieve yields of 6 to 7 per cent.

Momentum Global Investment Management investment director Glyn Owen says: "Defaults have been running at only around 2 to 3 per cent a year across the whole high-yield sector as companies have got their act together and have been able to refinance themselves very easily at low rates of interest because so much money has been flowing to the high yield bonds."

Clements reports increasing interest from clients in higher-yielding corporate bonds just below investment grade, about 80 per cent of the market being in the US and about 20 per cent in Europe.

He points out that the difference between BBB (investment grade) and BB (sub investment grade) can often be very slight and that you can therefore get disproportionately greater reward from the extra risk.

He says: "Because a lot of institutions will only invest in investment grade, if you look a little bit below there can be quite a good pool to fish in because demand has been depressed by the fact that rating agencies don't define these as investment grade."

Further trends in the fixed income sector include investing in bank loans and in distressed debt, “Interest in income has been boosted by the fact that pension fund populations are increasingly ageing, therefore creating a need to achieve a stable yield for longer”

especially in the commercial real estate sector, and an increased interest in multi-strategy products – where clients set the targets and the fund manager is left with more discretion than in the past.

Stone Harbor Investment Partners portfolio investment manager, investment grade fixed income, David Scott says: “The starting point for multi-strategy products is a greater bias towards the high-yielding emerging market corporate bond sectors, with the manager enjoying the freedom to move into the investment grade space to defend the portfolio. People are not so much distinguishing between emerging and developed markets but just talking about higher and lower risk.”

Equity income

Interest in equity income has also moved up a couple of gears. There has, in particular, been a trend away from single country equity income stocks towards more diversified global ones, but some newer regional stocks are also creeping into vogue.

Owen says: “Equity income has been particularly popular with pension funds since 2010, and in some cases companies are paying higher dividend yields than corporate bond yields. It used to be a developed market phenomenon but now the pensions industry is increasingly looking for equity income from emerging markets such as Asia, Eastern Europe and Latin America. This is an early trend and people need to be aware of the dangers because equities tend to have above average dividend yields for a reason.”

‘Big and boring’ global stocks can, on the other hand, yield slightly more than government bonds yet offer the potential for both dividend increases and capital growth.

Fidelity Worldwide Investment head of European equities Paras Anand says: “One of the key advantages to equities with a sound dividend yield is that, assuming that the underlying business has strong longer-term fundamentals, they will act as a good hedge against inflation. The 15-year dividend record of stocks such as Unilever and HSBC show that over time they have grown their dividends at several fold the rate of inflation on an annualised basis.

“It is surprising that headline yields on such stocks still look attractive, especially when you consider the sometimes negative rates of return being offered in the fixed income market for explicit inflation protection.”

US-specific stocks have also been proving fertile pastures for those seeking rising dividends. Edge Asset Management, a boutique of Principal Global Investors, focuses primarily on US- based strategies. It reports that 70 per cent of companies in its Large Value Strategies Fund (which invests in companies with a market capitalisation of $7 billion and above) have increased their dividends in the last 12 months.

Edge Asset Management president Jill Cuniff says: “We have experienced an increased focus from large European pension funds since late 2012 as people realised that the US was leading the way out of recession and that US corporates are in a very strong place, with lots of cash. We expect dividends to continue to rise for the next few years.”

Property and infrastructure

The quest for a substitute for low-yielding bonds to deliver a long-term low-risk income stream has also seen a focus on long-lease property, especially index-linked property. Traditionally, investment in this sector has been focused on offices let to government, quasi-government tenants, or to supermarkets, but the universe has broadened as a consequence both of a lack of traditional stock and strongly rising demand for this type of asset.

F&C Reit Asset Management director of property funds Ian McBryde says: “The growth area has been for assets such as hotels, student accommodation, health-care, data centres and other alternative property assets which are increasingly being bought by investors seeking long-term income. The long-lease market is becoming ever more complex and the nature of the assets underpinning it and their characteristics are changing. Investing in this part of the market is not therefore simply a box-ticking exercise.

“Over a long-term horizon fortunes can change at the company, town sector and building level, and indexation may lead to over-renting. Given that a significant proportion of the value of any long-leased index-linked property is attributable to the future income stream, there will always need to be a focus on the evaluation of credit, future earnings potential and the sustainability of income from the occupier.”

Infrastructure is also being appreciated for its ability to provide relatively stable income, with yields as high as 4 or 5 per cent, together with reasonable security. But the liquidity risk can clearly be a restricting factor. Defined benefit schemes tend to be best placed to take on this implicit risk but a new emphasis on governance since the financial crisis which has necessitated defined contribution schemes ensuring that their default funds are fit for purpose has also been a driver.

iShares head of UK Mark Johnson sales says: "Across Europe there has been a great deal of emphasis on what defined contribution default funds should look like. Around 10 years ago they largely consisted of cash, bonds and global equities but now we are increasingly seeing diversified growth funds targeting far more the requirements of retirees over time to build a pot that will typically seek to beat cash by 3 or 4 per cent a year.

"So infrastructure and other assets can play an important part. Infrastructure generally is very attractive as pension funds have obligations growing over time and infrastructure funds enable you to expect a rising income with reasonable certainty."

"We think the income hunt will continue for a few years but it's not for the faint hearted"

The future

There is a clear consensus that the preoccupation of European pension funds with higher income levels won't be ending any time soon, as it is being driven by a number of long-term trends.

Cardano client director Phil Page says: "We think the income hunt will continue for a few years but it's not for the faint hearted. Prices for income generating assets have risen a lot in the last few years and, if we get either a recession or a sharp rise in interest rates, many income performing assets will perform badly. Corporate bond holders could be worse hit."

The threat of a severe inflationary backlash – and subsequent hike in interest rates – resulting from the extensive quantitative easing programmes carried out by central banks still lurks at the back of many investment professionals' minds. After all, decision makers have been venturing into unknown territory. There is also the realisation that Europe still has a big debt problem and one of the easiest ways of dealing with debt is to inflate it away.

Nevertheless, economic forecasters do not seem to be losing too much sleep over the issue. Capital Economics is not expecting the European Central Bank to raise interest rates until at least 2015 and is even expecting a further 0.25 per cent cut later this year – with the rate then reverting back to 0.5 per cent by 2015. It feels there are a lot of issues in need of addressing that will hold back growth for quite some time, particularly in the peripheral eurozone economies, ensuring that inflation remains very weak.

The Centre for Economics and Business Research (CEBR) doesn't even expect European interest rates to rise until 2018 at the earliest, and is not anticipating rate rises in the US until 2015 or in the UK until 2016. Furthermore, in all these cases, when rate rises do eventually occur it expects them to be very gradual.

WRITTEN BY EDMUND TIRBUTT, A FREELANCE JOURNALIST

Counting the covenant

Post-financial crisis, schemes and their sponsors are looking to bring covenant risk under control, finds Andrew Sheen

The shadow of the financial crisis continues to loom large over pension schemes and their sponsoring employers. Five years on from the collapse of Lehman Brothers and the destructive financial tsunami it unleashed, firms across Europe remain embattled.

Data from German insolvency analysts Creditreform show that far from being over, European insolvencies increased in 2012, up 2.6 per cent over the previous year. While business failures in the UK fell 3.9 per cent from 2011 to 77 in every 10,000 companies, they rose by almost a fifth in the Netherlands from 6,176 in 2011 to 7,373 in 2012.

Simon Willes of Gazelle Group, which has developed a framework for the objective assessment of covenant risk, explains: "Declining or static economic growth will reduce the affordability of pension contributions as employer financial resources available to fund pension contributions comes under pressure.

"But this has been accompanied by quantitative easing and a prolonged period of low interest rates, which has been reflected in higher pension deficits and the need for higher pension contributions."

For pension funds that are forced to shore up funding levels by asking their employers for support, the current environment can make it difficult. Schemes looking to assess how readily available support may be have a variety of options. Mercer covenant consultant Tim Birkett says schemes should look at "the 'three P's' - performance, position and prospects", to assess what the employer is earning, its asset strength and future prospects.

But, says Willes, "covenant has not been measured quantitatively so far, with reliance on arbitrary scales of weak to strong or 1-10, which are very difficult to consistently translate into scheme funding arrangements".

In the UK, schemes are increasingly turning to measures such as forensic accountants to put their employer's balance sheets under the microscope and assess what level of financial assistance may be available. But assessing the strength of an employer's covenant is more than a mere financial test. As European pension consultants LCP head of corporate consulting Alex Waite notes: "If the money's there, is the employer willing to hand it over?"

Covenant risk

With the size of many pension promises built up over decades, there are an increasing number of

firms where the scheme's liabilities are comparable – even larger, in some cases – than the employer's market capitalisation.

Birkett says: "In many cases, the scheme is such a large creditor that it can effectively 'own' the company."

Unless employers are able to put measures in place to control costs, they may find that they are forced to divert a disproportionate amount of cashflow to support the scheme. Equally, trustees should enter negotiations with a spirit of compromise, recognising that they have a duty to ensure that their sponsor remain a going concern.

Barnett Waddingham partner and head of corporate consulting Nick Griggs says: "It all comes down to affordability. A lot of companies are looking at fairly lengthy periods to clear the scheme deficits."

Trustees should approach their sponsors with a view to acting in partnership, rather than taking a potentially combative, 'scheme first' stance. "A collaborative partnership can lead to outcomes that are more difficult in an adversarial relationship," Birkett says.

The spirit of compromise and ability to negotiate with employers is a positive, but for many schemes, their funding positions are so precarious that employer support is untenable without some kind of reciprocal action to control costs.

In the Netherlands, widely seen as one of the most mature and sophisticated DB markets in the world, schemes are able – indeed, legally required – to take action such as cutting benefits via the suspension of inflation-linked increases when their funding level falls below a certain point. This risk-sharing approach, which shares the burden between employer and members alike, means "the system is working", says Waite. The Dutch retirement age is also slowly increasing and will reach 67 by 2025, further easing pressure on the system. But employers are keen to cut costs where possible, and there has been a rise in the number of scheme closures, says Gert Kloosterboer, spokesperson for the Federation of the Dutch Pension Funds, which represents some 300 schemes across the Netherlands.

"Due to coverage ratios and book-keeping rules, companies are more critical about the pension contracts they have and their obligations. We're seeing that the relationship between pension funds and their sponsors is changing. Companies want to cut liabilities," he says.

"Trustees should approach their sponsors with a view to acting in partnership, rather than taking a potentially combative, 'scheme first' stance"

Irish experience

The Irish economy was one of the hardest hit in the first wave of the financial crisis, experiencing a peak to trough GDP contraction of 14 per cent in the two years from Q4 2007 to Q4 2009, according to the OECD. The Irish pensions regulator says that at the end of 2010 – the date for which the latest figures are available – Irish schemes had liabilities of €40 billion and a deficit of around €6 billion, or an overall funding ratio of around 85 per cent. But, says the Irish Association of Pension Funds director of policy Jerry Moriarty, this understates the size of the problem. While asset values have recovered somewhat since the height of the crisis, Irish accounting rules force schemes to value liabilities on an annuity buyout basis, which is expensive.

"There's no formal basis for assessing the covenant in Ireland, but it has become a big issue for trustees. There was the assumption that the employer will be there, but you can't really rely on that any more," Moriarty says.

"There's been a massive increase in schemes closing," he adds. "It's not quite as rapid as in the UK, but there have been hundreds in the past few years."

This is in spite of the Irish regulator taking the unprecedented step of suspending the requirement for schemes to submit recovery plans until earlier this year. Employers are also turning to members to renegotiate terms as a way to cut costs.

"They're cutting guaranteed future increases and changing accrual rates – even for accrued benefits," Moriarty says.

In the UK, the environment of 'pension protectionism' means employers cannot cut benefits as is the case in Ireland and the Netherlands in a bid to tackle costs, so many firms have been forced to close schemes outright. Mercer's Birkett notes: "We see a lot of companies grappling with these issues. We see discussions where businesses are having a hard time. It's up to the trustees to work to support the company."

Another recent development was the UK High Court's verdict in the long-running legal battle between The Pensions Regulator and bankrupt firms Nortel and Lehman Brothers over the correct legal and administrative treatment of the regulator's Financial Support

"An increasingly popular answer to improving a scheme's strength when an employer covenant may be weak is to put in place extra guarantees, such as asset-backed special purpose vehicles"

Directions (FSDs), which force employers to pay into and support schemes. Previous legal rulings had led to FSDs being treated as an expense of the administration, rather than a normal creditor. This meant the pension scheme would, as Birkett says, be "at the front, not even in the queue" for a payout in insolvency.

Adding protection

For schemes that need to draw on assets from their sponsor, but are unwilling or unable to cut benefits, there is a range of available options. First and foremost, they can ask for a cash injection from the sponsor, although as Griggs notes, there is a "question of affordability". Employers with weak covenants may also look to restructure their financial arrangements – not least to strengthen their own positions – through the renegotiation of loans or financing terms with banks and creditors.

An increasingly popular answer to improving a scheme's strength when an employer covenant may be weak is to put in place extra guarantees, such as asset-backed special purpose vehicles. These range from giving the scheme rights to physical property like buildings, to intellectual property rights such as patents, copyright or brands, to physical assets, such as the oft-cited 'whisky mortgage' by international drinks giant Diageo.

Says Derbyshire: "To a certain extent, staying within the law, the only limits are the abilities of the scheme and the imagination of its advisers."

While these kinds of solutions were once the preserve of the very largest employers, Griggs says they are "starting to filter down", although there is a limit. "The main barrier is professional fees associated with putting them in place, or that employers don't have the assets to put into these vehicles."

For schemes that have come through the crisis, Birkett suggests 'fixing the roof when the sun shines' and talking to the sponsor about measures to protect the scheme, such as asset-backed solutions, when they're not borne of desperation.

"It's a tough thing to do in hard times – do it in the good times. Talk to the employer when the pressure isn't on," he says.

WRITTEN BY ANDREW SHEEN, A FREELANCE JOURNALIST

Joining together

With so much demand for infrastructure investment, pension funds are said to be the ideal match for such projects. Nick Martindale discusses if this is indeed the case and what schemes should look for

Many European countries are currently facing something of a dilemma when it comes to infrastructure investment. Projects such as new energy, road or rail infrastructure – as well as schools and hospitals – are great drivers not only of social prosperity but also economic growth, yet governments are unable to bankroll them, and banks no longer have the appetite or capability to take on such long-term commitments.

This can cause all-too-obvious shortfalls. A recent report by EC Harris predicts a rate of increase of just 2.7 per cent in built assets in Europe over the next decade, compared to 19 per cent in the US and an average of 35 per cent across 30 countries, which represent 32 per cent of global GDP.

This, though, is a gap which is being increasingly targeted by institutional investors, including pension funds. "Both infrastructure debt and equity are a natural fit for European pension funds," says BlackRock managing director, infrastructure debt platform, Chris Wrenn. "Most recently we have seen strong interest in infrastructure debt as a low-risk but higher-yielding alternative to sovereign and corporate debt, but demand for European infrastructure equity also remains strong as pension funds seek to benefit from the long-term cash flows and inflation protection that infrastructure assets offer investors."

Macquarie Infrastructure and Real Assets has also seen an increase in interest, and recently closed its fourth European infrastructure funding round, raising €2.75 billion. "In Europe, we are seeing both new investors entering the sector and existing investors increasing their allocations," says senior managing director Arthur Rakowski, who is also a member of the European Investment Committee responsible for institutional relationships. "More

"The fact that infrastructure is not directly linked to other asset classes also makes it attractive from a diversification perspective"

than 60 per cent of investors in this fund are European institutions. It is also interesting to note that some countries, previously not very active in this sector, have now become major sources of capital for private infrastructure funds." Germany is the best example here, he says.

Infrastructure offers a number of potential benefits for pension funds. "The main advantage is that most project finance bonds compare well to corporate bonds in terms of default rates, loss-given-default and also in terms of the credit rating," says Pension Insurance Corporation investment manager Allen Twyning. "Corporate credit ratings typically migrate downwards over 30 years, whereas you would expect a PFI bond's credit quality to improve over time as the project de-risks."

The long-term nature of returns fits in well with pension funds, suggests First State Investments head of institutional relationships EMEA Fraser Wood. "Well-managed investment in core infrastructure assets can deliver sustainable and predictable cashflows that are very valuable to institutional investors in an otherwise uncertain and volatile investment landscape," he says. "This is especially the case now that pension funds are entering a phase where they are cashflow-negative and require stable and inflation-linked income streams from underlying assets."

The fact that infrastructure is not directly linked to other asset classes also makes it attractive from a diversification perspective, says EC Harris global account leader Weng Lee. "It can contribute to a diverse portfolio strategy while also offering a long-term structure, with stable, inflation-protected income flow once constructed," he says. It's a particularly attractive market just now, he adds, with the Organisation for Economic Co-operation and Development estimating there is a global need for infrastructure investment of $50 trillion between now and 2030.

Despite this, however, there is a degree of reluctance from some investors to get involved. Standard & Poor's managing director, infrastructure finance, Michael Wilkins identifies three main reasons: a lack of familiarity with project risk, caution regarding the lack of historical performance data, and concerns around the potential emergence of another asset bubble similar to the one in 2008.

"Within project finance, construction risk – that associated with ensuring that a project is constructed and completed on time, to budget and capable of operating as designed – is regarded as a particular source of concern," he says Estimating the amount of credit support required to complete a project is also a concern, while even operations contracts are open to disagreements. The overall outlook is more positive, though; 80 per cent of European projects were investment-grade as of the end of March this year, compared with 76 per cent as of end of September 2012, adds Wilkins.

Industry Funds Management investment director, debt investments, David Cooper suggests investors can reduce risk by sticking to relatively simple projects such as schools, and points out that construction companies are unlikely to fail to deliver at all on a project involving the government, unless the business itself becomes insolvent.

"But there are particular areas where investors need to be especially careful," he adds. "These would include exposure to greenfield deals exposed to significant and unproven revenue risks such as newbuild toll roads; exposure to deals where the project performance depends to a significant degree on a counter-party or contractor which doesn't have the wherewithal to adequately absorb that risk; and deals where the investor is taking significant sovereign non-investment grade credit risk through the project's payment mechanism."

There are already some signs that investors may be becoming more wary about investing in infrastructure, says bfinance senior associate, private markets team, Jorge Huitron. "We continue to see interest from institutional investors but they are becoming increasingly selective as the perceived benefits of infrastructure have often been elusive," he says. A recent analysis by bfinance found out that more than one in three infrastructure investments ultimately generate losses for their investors, he adds.

As with any asset class, some investments are riskier than others. Cooper points to countries such as

“Investors can reduce risk by sticking to relatively simple projects such as schools”

the UK, France, Belgium, Germany, the Netherlands, Ireland and Italy as offering good opportunities, on the back of a need to renew and develop infrastructure. “As all these countries are, to a lesser or greater degree, fiscally constrained they will be relatively dependent on private finance from institutional investors,” he says. “Even in countries suffering from significant fiscal constraints there are likely to be good opportunities to invest in stable, high-quality infrastructure that are largely insulated from wider sovereign credit concerns.” Investors should be able to receive returns of 2 per cent or more above the Libor rate for senior debt, he says, and 3.5 per cent for junior or weaker debt investments.

Standard & Poor’s Wilkins also highlights Northern Europe as an attractive option from a risk perspective but suggests the successful closing of the €1.43 billion project bond for the Watercraft Capital underground gas storage facility in Spain indicates investors are willing to look at Southern European countries too. “This project benefited from strong support from the European Investment Bank through the use of project bond credit enhancement that provided some mitigation to the sovereign risk issues,” he says.

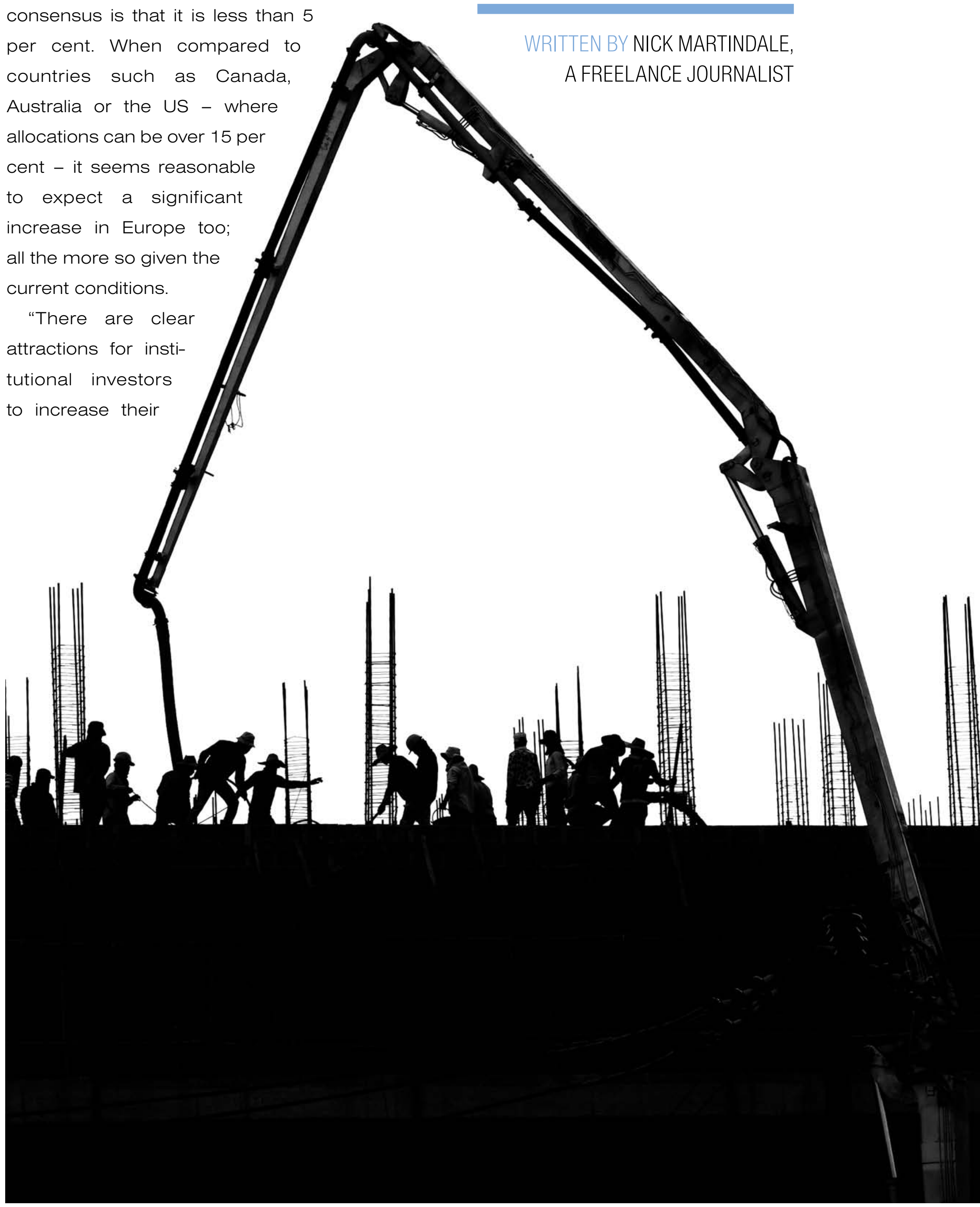
The renewable power generation sector is currently proving popular, adds Impax Asset Management head of distribution Ominder Dhillon, on the back of declining technology costs, a shortfall in electricity generation capacity and attractive pricing in countries such as France and Germany. “It’s early days but we are also interested in the Finnish onshore wind market,” he says. “Not that many institutional investors appear to be targeting it at the moment so it could be an early-mover opportunity.”

Estimates vary as to just how much of the typical European pension fund is invested in infrastructure projects, but the general consensus is that it is less than 5 per cent. When compared to countries such as Canada, Australia or the US – where allocations can be over 15 per cent – it seems reasonable to expect a significant increase in Europe too; all the more so given the current conditions.

“There are clear attractions for institutional investors to increase their current allocations to infrastructure, with the level of allocation being driven by the investment objective and liabilities of the fund,” says Wood.

“We could see a strong case for an allocation of 10 per cent of a client’s portfolio, either being funded from the current bond allocation or maybe from an alternatives allocation to complement their current bond holdings.”

WRITTEN BY NICK MARTINDALE, A FREELANCE JOURNALIST



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More room for growth?

Buyout volumes were disappointing in 2012, but does this mean there is no longer growth in the market? Pádraig Floyd reports

Buyout is not a sexy subject, but it gets the straightest-laced of the pensions fraternity hot under the collar. It is the endgame – the dénouement or money shot – plan sponsors, trustees and their advisers have been working towards for years. For some, the buyout market has been dragging its heels of late. It's fair to say the financial crisis and subsequent economic environment have made it difficult to write business as schemes have found it a little rich for their blood. But many thought 2012 would be a big year for writing business, so when it failed to come to fruition, there was some disappointment.

Down but not out

Although the UK buyout market is down on previous years – around £4.5 billion compared to £5 billion in both 2010 and 2011 – this doesn't show a massive contraction and indicates where the market was, says Buck Consultants senior consulting actuary (de-risking) Tony Winterburn. "Buyout tends to be dominated by the bigger deals, of which there are smaller numbers. Nothing happens for a while and, a bit like buses, they tend to come along together."

Business has been reasonably steady this year, and is believed to be shaping up to be the biggest since 2008. "It's moving in the right sort of direction," says Winterburn, "but like any market, it's driven by affordability."

The chances of 2013 beating recent records are good, as more than £3 billion of buyout has been written already, according to figures from LCP. Almost half of this is accounted for by the record-breaking EMI deal worth £1.5 billion.

The front runner is Pension Insurance Corporation (PIC), which is responsible for writing almost £2.3 billion of buyout and buy-in business, including the EMI deal and a £160 million buy-in by the First Quench Pension Fund, giving it a market share of 70 per cent to date.

Legal & General is currently in second place, with first half figures of £565 million, while Rothesay Life has written £190 million in respect of the pensioner buy-in by Smith & Nephew's plans in May.

Business has picked up for a number of reasons. "There has been a general improvement in asset values and funding position over past two years, making buyout more appealing, or for those with large amounts of gilts, pensioner buy-ins," says Winterburn.

This improvement in funding positions is reflected in the UK's Pension Protection Fund's 7800 Index. This showed the aggregate deficit for the 6,300 schemes it monitors was down to £116 billion, the lowest in two years, while the funding ratio was up from 89.1 per cent to 90.7 per cent.

The index also recorded 1,748 schemes – one in four – in surplus of an ongoing basis.

This is leading to a change in culture. Schemes are now going to insurers and asking not only for quotes, but the conditions under which they would transact. If the price is too high, they will park the process, but it means a lot of the heavy digging has already been done.

"It means the scheme can go back when the timing is right and the contracts that have been awarded can be drawn up," says Winterburn.

"There has been a general improvement in asset values and funding position over past two years, making buyout more appealing, or for those with large amounts of gilts, pensioner buy-ins"

Buyout back on the agenda

Buyout may seem nothing but a pipe dream for many schemes, but that belies the reality, says JLT director, head of buyouts Martyn Phillips.

JLT has completed around 15 deals in 2013, half of which have been full scheme buyouts, which Phillips admits is a high proportion. This is often driven by an overseas parent with a relatively small scheme – between £5 million and £15 million – that is worried about carrying that liability on its balance sheet. With its home market perhaps leaving recession behind, it may seek funding in the near future and doesn't want this hanging over it.

"Since the financial crisis, many employers have been stockpiling cash and not spending their capital," says Phillips. "They are therefore looking to use this reduce or remove those liabilities. As a result, quite a number are coming forward to transact."

And it isn't only overseas schemes, says Phillips, who is working with a UK scheme with several billion pounds of liabilities as buyout has now become a distinct possibility. Phillips is also being kept busy with demand for longevity deals, but PIC's co-head of origination Jah Shah warns against getting carried away by the numbers associated with these contracts.

"There is a more subtle story around longevity swaps," says Shah. "On face value, these deals are huge – BAE's £3 billion deal for instance – but it isn't a sensible way of presenting that business, for while the liability may be £3 billion, the size of the deal is considerably less."

There are very good reasons for using longevity swaps, says Shah, but they are only going to be appropriate for large, sophisticated schemes that have no intention of running off for up to 50 years. As a result, it is no surprise these deals are large, though expectations of

more and larger deals have yet to filter through.

Overseas interest

Another market developing slowly is that of Europe in a wider context. It is underdeveloped, largely because defined benefit schemes are confined to certain jurisdictions, particularly the Netherlands and Scandinavia.

They don't always face the same issues, with lower equity exposure and assets better matched with bond-like instruments. "There is also less of a practice of discretionary increases in benefits," says Shah, "so it's not the same position as UK schemes find themselves in.

"However, we do have inbound enquiries, so there is interest, with schemes watching the UK market and the Irish market, which is a lot closer to the UK model."

The fact that L&G has broken into the Irish market with reinsurance of Irish annuity books bodes well for growth in European deals, adds Shah.

That demand works both ways too, says Phillips, as the insurance companies may see the opportunity to diversify both their longevity and investments across their general book. Though a fraction of the UK's potential £1.5 trillion, it could still amount to several hundred million pounds in liabilities that requires coverage.

Breaking into this market requires scale and there are concerns about the number of players in the market just in the UK. With Rothesay Life and MetLife believed to be up for sale, this has constricted the market and despite the rigorous protections placed around sold insurance books, there is nervousness about doing deals with an entity that may not exist much longer. This, in turn, may have an impact on price.

"It's a fine balance for healthy competition in the marketplace and the natural policing of prices could be affected," says Phillips. "Prices could go up in response to supply and demand, but then we won't see deals unless they are done at a sensible price."

The whole market in his hands

The issue of price is always a sensitive one, but one innovation may prove a game changer, particularly for some small schemes.

One way of guaranteeing you only pay for what you're going to use is to have an underwritten process. The drawback with this is, unless you want to write to all your members with forms for each of the different providers, you are forced to commit to one, limiting the choice of quotes.

But JLT is confident it can now run a whole of market search among the insurance companies quoting at the lower level – Aviva, Just Retirement, L&G and Partnership. It has developed a common form that is in pilot and Phillips believes this could have a considerable impact on many smaller schemes looking to buy out.

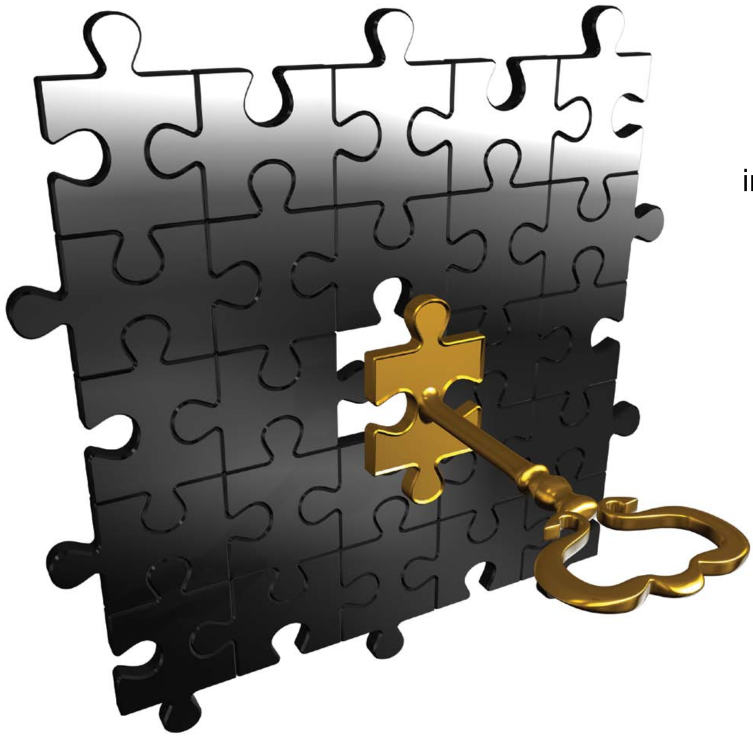
"The ability to hold a whole of market exercise will break the cycle of loading somewhere in the pricing due to uncertainty about the members."

Though some small schemes will pay less, he concedes those with a healthy population will pay more, but argues the system will be fairer.

"And just as with car and house insurance, each insurer likes different risks, so schemes will likely receive different rates for different impairments, giving them better options for their members," he adds.

The pilot is already underway and JLT is looking at schemes with liabilities as high as £30-£40 million. And with several thousand small DB schemes in the market, buyout may no longer be an unobtainable dream, particularly for small employers.

WRITTEN BY PÁDRAIG FLOYD, A FREELANCE JOURNALIST



Convertibles have seen higher inflows lately, as risk-averse investors move away from rising bond yields without wanting to buy into equities directly. Peter Carvill looks at the increased interest in the asset class and how it can play a role in a pension fund's portfolio

Unlocking their potential

The New Year opened with a bang when Abengoa, an unrated Spanish company, responded to an over-subscription of its bond issue by increasing the size of the deal from €250 million to €400 million. That deal would have been unthinkable six months before. However, a mere six months further on, such a move can now be seen as reflective of the bull market around convertible bonds.

The aforementioned are fixed income instruments that can be converted later into shares. Switzerland-based RMF Investment Products calls them "fascinating hybrid securities" in its *Convertible Bonds: An Introduction to the Asset Class*. "On the one hand, they have the benefits of debt instruments that pay fixed coupons and will be redeemed at maturity at a pre-specified price. On the other hand, the embedded conversion option provides the investor with a participation in the upside potential of the underlying equity."

In recent years, however, convertibles have been seen as being under-utilised. Aviva Investors global convertibles fund manager Justin Craib-Cox says: "That was mainly because the market dried up for risky-type assets as rates kept moving lower and lower because of the central bank measures. That gave other markets such as high-yield the incentive to raise a lot. They came along to companies and said to people, 'We have a great deal for you. You can issue 10-year paper with a low coupon, even if you're considered to be high-yield.' It was a once in a lifetime chance to get this issuance through because issuers were locking in rates. To say 'under-utilised' implies they should have been using convertibles and of course that's up to the issuer. If they thought they were getting a better deal on the high-yield markets, well so be it because there's nothing wrong with that but if you compare historical issuance levels with what you saw happening in 2011, you would have thought it a quiet period for the market."

However, data now supports an assertion of a bull market, with European companies having issued $6.8 billion in convertible bonds for thE year to 6 February 2013, compared with $350 million over the same period last year, Dealogic said.

CQS portfolio manager Alex Schoenenberger says: "We've really started seeing interest in the product over the year, and there has been a lot of inflows still going on this year.

Clearly, that's been a function of the returns over the last 15 years. If you look at the UBS index, you can see that they outperformed by miles." He adds: "And clearly one of the reasons it has outperformed is that it has been overlooked. If you go back to 2008, there was a lot less in convertible bonds. That's why we think there are great opportunities out there."

UBS' Global Convertibles Indices also support the idea of a once-ignored market suddenly punching above its weight. Taking the beginning of August as a cornerstone, index value rose from 233.65 to 260.66 between 2010 to 2011, dipped between 2011 and 2012 to 250.53, but had rocketed to 295.08 by 1 August 2013. Year-to-date and year-on-year figures are also illustrative: the former show values of 2.49 per cent, 2.31 per cent, 5.77 per cent and 9.92 per cent; while the latter show 14.82 per cent, 13.02 per cent, -3.89 per cent, and 17.78 per cent.

An analysis of the world's economy also provides a backdrop against which to quantify the rising demand for convertible bonds. BlueBay Asset Management's *Wavelength: Convertibles... Equities with Convexity*, published in March this year, outlined where the pushes and pulls of the financial landscape were. It said: "There are many arguments that favour a positive outlook for global equity markets; tensions in the eurozone have eased significantly, recent US earnings numbers are positive, the Chinese economy is resurgent, and the recently-installed Japanese government is pursuing equity-friendly policies. However, all is not plain sailing ahead; the eurozone remains in recession as austerity measures hit growth, the US has to negotiate the government spending cuts that are a result of the sequester while the significant devaluation of the Japanese yen in recent weeks has led to an increased risk of 'currency wars'. Due to this uncertainty, equity markets could experience further periods of retracement and volatility. Indeed in each of the last five years global equity markets have experienced pullbacks of greater than 10 per cent. Given this investment backdrop, we believe convertible bonds appear to offer an attractive option to investors, whereby they can increase their equity exposure with potentially much lower volatility of returns."

Schoenenberger adds further colour and offers this view: "While convertible bonds, which in their simplest form are corporate bonds with embedded equity call options, have been one of the least advocated asset classes since 2008, they have in fact performed well over the last few years. Furthermore, we believe that convertibles are attractive and there are significant opportunities due to valuations dispersions. We also believe that in this difficult macro-environment, the convertible market is supported by a number of strong technical factors, which can be expected to provide both stability and an investment universe that is rich in opportunity. We are positive on the convertible asset class and believe they continue to offer an excellent risk-adjusted return profile for the following reasons: valuation dispersion is creating substantial opportunity; a better balanced ownership profile of the asset class means greater stability and lower volatility; greater valuation dispersion within the convertible market provides additional opportunity for alpha generation; and geographical diversity provides particular opportunities for global investors."

Another reason, offers BlueBay Asset Management partner and senior portfolio manager Mike Reed, is a perception that they can be a safer haven than equities. "Convertibles have a volatility of 8 to 9 per cent while equities have a volatility of 16 to 17 per cent," he says. "With similar returns but half the volatility than you get on a risk-adjusted basis or any other sorts of value of risk measure, convertibles have proved to be a very attractive asset class. On the back of that, they're attracting a lot of inflows. Our fund, which we launched in 2008, now has assets under management of over $2.5 billion."

As to where convertibles fit into a pension fund's portfolio, Schoenenberger posits that they can be an instrument of optimisation. Convertible bonds, he reckons, improve the portfolio, meaning that investors can get more returns for less risk – the best of outcomes.

UBP head of convertibles Nicholas Delrue adds depth to this view. "If you look at the broader picture," he says, "what these bonds do is fit into a diverse portfolio because they enhance the risk return of equities. In the long term, convertibles would be expected to deliver equity returns but with more or less half of the volatility. The reason is that, as their name implies, they are convertible so they don't just have a bond profile, but also an equity option. That gives it a dual return profile. What we try to do is cheap optionality, which is making sure you're getting cheap options that give you more exposure, for not that much, to the upside of equities and with more of a bias towards an investment-grade type of credit."

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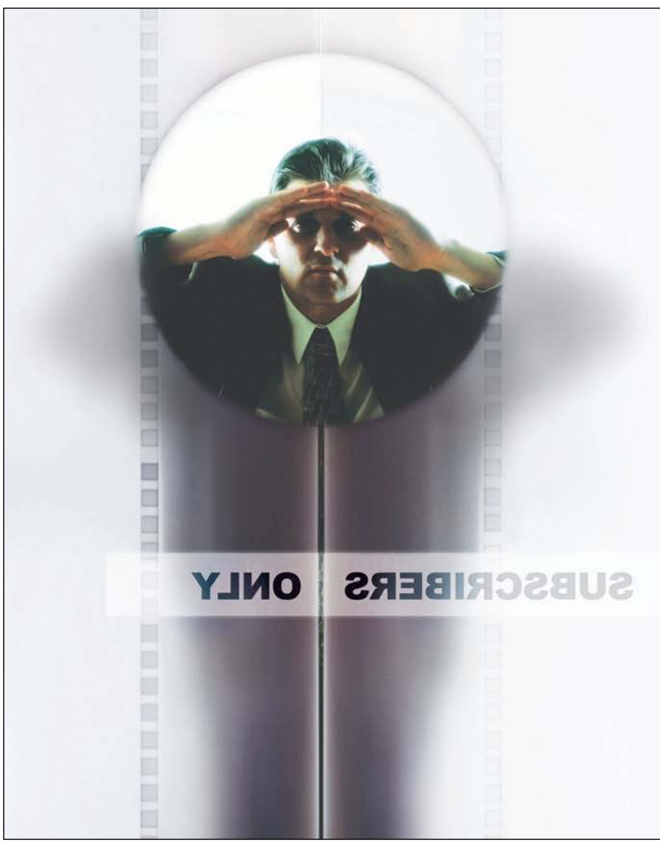

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Source: Schroders, A Acc share class, bid-to-bid, as at 31 July 2013.

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