European Pensions

February/March 2015

Keeping things sweet

SWISS PENSION FUNDS ENDED 2014 ON A HIGH, BUT CAN THIS SUCCESS BE MAINTAINED?

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See page 24 for an interview with Norwegian pension fund KLP

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Times are changing

Welcome to the first European Pensions for 2015. The new year is always time to look ahead, so it is only appropriate that our theme for this issue is 'change'. Not just over the next 12 months (although we do cover that on page 16), but also further ahead, asking ourselves once the myriad transformations - such as the withdrawal of second pension pillar provision in some Eastern European countries, the experimentation with various structural models and the possible increase in cross-border pensions - are 'bedded in', exactly what shape will European pension provision be left in?

New policies are not the only changes requiring pension funds to adapt. Whether it is immediate concerns, such as falling interest rates and growing deficits, or more 'slow-burn' affairs, such as the ever-increasing longevity of members, schemes have to be prepared and manage them all, without letting the standards of service slip. There are certainly tools to help with this, and the sector is increasingly using technology to automate elements of pensions management, but ultimately it is down to the skills of those running the team and their supporters.

THROUGHOUT EUROPEAN PENSION SCHEMES, VOLATILITY SEEMS TO BE THE ORDER OF THE DAY

One country that has seen its pensions industry more than rise to the challenge is Switzerland, which ended 2014 with its schemes on average fully funded. However, as we warn on page 26, it will be no easy task for them to remain in this positive state, with the Swiss National Bank (SNB) dropping its peg to the euro – wiping out an estimated CHF 30 billion of pension fund assets, the cutting of interest rates and the Swiss stock market dropping 9 per cent in one day being just some of the trials requiring pension funds to respond.

Switzerland is not unique in having these market pressures, which require a fast response, while trying to put out the slow-burning fires of increasing longevity and structural reform.

Throughout European pension schemes, volatility seems to be the order of the day. At the moment, it seems the only constant we do have is that the industry will continue to change.

Laura Blows, Editor

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

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EIOPA pushes for IORPs to prioritise greater transparency on costs

THE UK'S ASSOCIATION OF CONSULTING ACTUARIES WARNS IORP II REGULATION WILL 'KILL OFF' DB CROSS-BORDER MARKET

Written by: Lauren Weymouth

The European Insurance and Occupational Pensions Authority is pushing ahead in its call for IORPs to be more transparent on costs and charges.

As part of its urge for greater clarity on costs, EIOPA recently published a report on costs and charges of IORPs to ensure all parties can be clearer about the value for money or affordability they can deliver, since these may have an "important, and potentially detrimental, impact on the accrued benefits or calculated contributions".

The European regulator said it would be "beneficial for all parties that bear costs and charges in IORPs if all costs and charges within the value chain are disclosed transparently and comprehensively to the parties bearing them".

The regulator added: "When this is the case those parties are able to assess if the costs and charges they are paying represent good value for money, and disclosure of 'costs and charges' information better enables all parties to exert market pressure on costs."

In its report, EIOPA said the findings of a survey among EIOPA members indicated it is "highly difficult" among a significant number of member states to ascertain a "clear, comprehensive and foremost accurate picture" of what they are paying. Furthermore, EIOPA said as there continues to be an ongoing shift to DC pension schemes in many member states, it is especially important costs and charges are understood in the IORP space.

The regulator also said national competent authorities should have effective means to assess costs and charges to be able to judge how these affect value for money or the affordability of the pension schemes provided.

EIOPA added it intends to take "further steps" to address these issues, taking due note of the national initiatives that have already proven effective in this field and the differences in the IORP systems.

On the issue of IORP II legislation, the UK's Association of Consulting Actuaries recently warned that the introduction of the power for the regulator to block the transfer of assets and liabilities in the transferring state will kill off the nascent defined benefit cross-border market.

At present, under article 13(5) of the revised IORP II Directive, the regulator is provided the right to refuse to approve the transfer if it believes the beneficiaries' security would be threatened. However, ACA said contrary to popular belief, a number of multinationals have successfully established cross-border DB pension funds under the existing IORP Directive. It added the process typically involves Belgian, Irish and Dutch sections and billions of euros of assets have already or are currently being transferred.

"It is perverse that a directive, which has as one of its objectives the encouragement of cross-border pension plans should, as currently drafted, make it extremely difficult to do so," ACA International Committee chair Paul Kelly said.

"Multinationals will be extremely reluctant to invest the time and effort in working with all the stakeholders to proceed with the transfer if the transferring regulator can simply refuse to transfer on the grounds of their opinion," he added.

"It also means that it will be more difficult for multinational companies to sustain existing mature DB plans without the tool of combining these together. It appears that this nascent market has been the victim of EIOPA's push for harmonised funding and the nationalistic concerns of individual regulators."

Global pension fund assets reach $36trn high, Towers Watson says

GROWTH A CONTINUATION OF A TREND STARTED IN 2009 WHEN ASSETS GREW BY 18%, COMPARED TO 22% FALL IN 2008

Written by: Natalie Tuck

The global pension fund assets in the 16 major markets grew by over 6 per cent during 2014, reaching a high of $36trn, according to Towers Watson.

The Towers Watson Global Pensions Assets Study found the growth is a continuation of a trend that started in 2009, when assets grew by 18 per cent; a contrast to the 22 per cent fall in 2008. Since 2004 global pension fund assets have grown on an average of 6 per cent per annum in USD.

The research showed DC assets grew rapidly in the 10-year period to 2014, with a compound annual growth rate of 7 per cent, compared to 4 per cent for DB assets. As a result DC pension assets have grown from 38 per cent of all pensions assets in 2004 to 47 per cent in 2014 and are expected to overtake DB assets in the next few years.

Towers Watson global investment director Roger Urwin said DC assets will soon account for the "majority of global pension fund assets" and are becoming the "dominant global pensions model".

However, he added the shift brings with it a "transfer of risk" and a new tension in the balance of control and ownership, which will test governments and pensions industries.

"The acid test for national pension systems should be to get assets to at least 150 per cent of GDP"

"These billions of new pension members have high and immediate expectations in a world of low returns and in many cases where the benefits of pooling are not fully exploited. This pressure is likely to accelerate the emergence of a more effective "value chain", where expense on various activities has a better value proposition than exists today," he said.

He explained the use of passive approaches and smart betas in DC will lead to fee compression, which is likely to become a large disruptive force over time.

According to the study, pension assets now amount to around 84 per cent of global GDP, substantially higher than the 54 per cent recorded in 2008. Urwin stated despite improvement to pension balance sheets world over, many DB schemes are still in a very weak solvency position.

"With global pension assets at only 84 per cent of global GDP, the pensions industry gets quite poor marks for providing good value for the worker and pensioner populations. The acid test for national pension systems should be to get assets to at least 150 per cent of GDP," he said.

In addition, the research found a reduction in home bias equities as the rate in domestic equities in pension portfolios fell on average from 65 per cent in 1998 to 43 per cent in 2014. UK exposure to domestic equities has more than halved to 36 per cent, since 1998. The US maintained the highest bias to domestic equities from 65 per cent in 1998 to 43 per cent in 2014.

Urwin said this shift away from domestic equities is one indication of an increased focus on risk management.

Irish govt's pension levy 'legal but not necessarily fair', Ombudsman states

IRISH PENSIONS OMBUDSMAN PAUL KENNY SAYS LEVY HITS PAYMENTS TO PENSIONERS

Written by: Natalie Tuck

The Irish Pensions Ombudsman has stated in a letter to the Oireachtas finance committee that the government's 0.6 per cent pensions levy on private sector pension schemes in 2011 was "legal but not necessarily fair".

The letter from Paul Kenny, Ombudsman since 2009, seen by *The Irish Times*, states that the levy hits payments to pensioners as trustees sought to share the burden among scheme members.

In paying out the levy, amounting over four years to 2.4 per cent of the value of the assets held, trustees were faced with a permanent reduction in the assets they had to 'back' the pensions already in payment, he stated in a three-page letter sent to the clerk of the committee on 22 January.

"Trustees were faced with a permanent reduction in the assets they had to 'back' the pensions already in payment"

He stated most trustees felt they had no choice but to reduce pension payments to current pensioners or the full brunt would have been borne by future retirees.

Kenny said that, in "most cases", the effect of the reduction in payment would "last for the lifetime of the pensioner", according to *The Irish Times*. This contrasts with the public sector pensions levy which, "although it is very high, is intended to be temporary".

In relation to the impact on defined benefit schemes into the future, Kenny said it was "conceivable" a number of the funds would survive in a modified form but that trustees would still impose the charge on pensioners.

"They would have to do this, even if the schemes could afford to pay the full benefits, simply because they would be treating current pensioners unfairly vis-a-vis the rest of the members," he explained.

Kenny closed his letter by stating that the levy would result in a "permanent reduction in the annual pensions of a great many scheme members".

The levy was introduced by Minister for Finance Michael Noonan in 2011 to fund a reduction to 9 per cent in VAT on tourism services to create jobs. It was levied at 0.6 per cent in the first four years and 0.15 per cent this year, when it will end. It has delivered more than €2.1 billion to the exchequer in revenues.

In another Irish legal case, The Irish High Court has ruled to allow The Pensions Authority to replace administration and trustee company Source Pensions with another company to manage around 180 pension schemes.

It was reported in the Irish Independent that Trustee Principles Ltd will take over the schemes from Source Pensions for a year.

Source Pensions was also told it is not to act as a trustee for another five years unless it makes an application to the court. Justice David Keane granted the order and there was no objection from the counsel for Source Pensions.

Under The Pensions Act 1990, the authority has power to carry out investigations into alleged breaches of the Act and to ensure pension administrators and trustees comply with their obligations to current and former employees. As part of these powers, the authority is permitted to conduct on-site visits without notice, seize and copy relevant documents and to prosecute any person that contravenes the provisions of the Act.

Dutch pension system needs a 'fundamental overhaul', DNB says

REGULATORS TO PUT DUTCH PENSION FUNDS UNDER 'SUBSTANTIAL PRESSURE' IN 2015, SEI WARNS

Written by: Lauren Weymouth and Natalie Tuck

Changes are needed to the Dutch pensions system if pensions in the Netherlands are to be sustained in the long term, De Nederlandsche Bank has said.

The Dutch bank said this is due to demographic ageing, a changing labour market and other trends in society that require improvements to what is currently a "unique and solid pension system".

According to the DNB: "A new, future-proof pension system is characterised by clear ownership rights for pension scheme members, a fair distribution of risks among the various generations and gradual absorption of financial shocks to maintain macroeconomic stability."

The recommendations for improvements to the country's system come as part of the DNB's contribution to the national pension debate, which was launched last summer by State Secretary of Social Affairs and Employment Jetta Klijnsma. The debate is about the future of the Dutch pension system, aiming to identify "building blocks" for making the system "future-proof".

DNB specified that one of the key elements to a sustainable pension system is clear ownership rights, highlighting the importance of making sure members are more aware of what claim they have towards their fund and what adjustments are made to it in the event of financial shocks or increases in life expectancy.

"Such transparency makes members more aware of their pension, allows them to have more realistic expectations and enables them to make sound financial plans," the bank said.

DNB also called for fair distribution of risks and rewards as the current system has "opaque re-distributive elements that tend to be difficult to justify".

Furthermore, it said the overhaul would also require scheme members to be provided with more tailor-made solutions, allowing younger members to take higher investment risks.

"The current pension system has a one-size-fits-all structure, which fails to do justice to the variety in risk-bearing and savings capacity among pension scheme members," DNB said.

An additional adjustment, as recommended by the DNB, would be made to contributions to support economic stability.

"A future-proof system should prevent contributions as much as possible from fluctuating with economic conditions. The best way to achieve this is to absorb financial shocks by making gradual adjustments to pension benefits," it added.

SEI also warned recently that Dutch pension funds are likely to be put under 'substantial pressure' by regulators and the general public in order to be more transparent on costs.

According to the firm, Dutch funds will experience pressure to be more transparent, not only on management fees but also on performance fees, investment transaction costs and costs related to administration of participants.

SEI Institutional managing director of sales Peter in de Rijp said additionally, 2015 is likely to see the Dutch pension fund market shrink considerably.

"By the end of 2015 we will definitely see a smaller number of pension funds but their size in terms of assets under management will be growing due to mergers and take-overs," he said. "We are also seeing smaller industry-wide funds that operate in stagnating or even shrinking sectors of the Dutch economy looking at merger opportunities."

PensionsEurope expresses concern over Bulgarian pensions

INDUSTRY BODY STATES NEW REFORMS 'JEOPARDISE THE EXISTING MULTI-PILLAR PENSION SYSTEM'

Written by: Natalie Tuck

PensionsEurope is concerned by the reforms taking place to Bulgarian supplementary pensions, which allow employees to transfer their pension fund assets into the public pay-as-you-go system.

In a statement released by PensionsEurope, the industry body stated the reforms "jeopardises the existing multi-pillar pension system".

The Bulgarian pension system contains three pillars: a mandatory PAYG system, a mandatory second pillar and a voluntary third pillar. The second pillar consists of universal pension funds (UPFs) and occupational pension funds (OPFs).

The UPFs cover employees (regardless of their job category) and the self-employed. Participation in UPF is compulsory for all workers born after 31 December 1959. Those pension funds are fully-funded DC schemes with individual accounts.

Five per cent of the overall social security contributions (17.8 per cent) are redirected to this funded pillar, and members choose their provider. All workers born after 31 December 1959 also participate in the PAYG first pillar, however with a lower contribution of 12.8 per cent.

Occupational pension funds (OPFs) are early retirement schemes, targeted to employees working in hazardous environments. They are also fully-funded, DC schemes with individual accounts. Contributions to occupational pension funds are made exclusively by employers and depend on the employee's job category.

The government is reforming the system in such a way that UPF members will have to choose whether to continue their parallel participation in a pension fund or to participate only in the public system and transfer all accumulated assets into the public pay-as-you-go system. Pension contributions that are currently channelled to the UPFs will be paid into the public system.

Accumulated pension savings in the individual accounts of the members will also be transferred to the public system. Bulgaria's public pension system does not have individual accounts, and thus the transferred funds would be swallowed up in the PAYG system.

Employees joining the labour force after 1 January 2015 will have the opportunity to decide whether to participate in a pension fund within the first year of their employment. Once the decision is made, it is irreversible. If an employee does not exercise this right to choose, they will enter the public PAYG system without an option to change the decision later.

PensionsEurope described the decision as "remarkable" as employees are made to choose between two systems of retirement provision that are non-comparable by nature: a PAYG and a fully-funded system.

PensionsEurope chair Joanne Segars said the reform "undermines" the role of funded pension schemes in the pension system and the economy. "We are convinced that efficient multi-pillar pension systems are a key element in order to provide good, adequate and sustainable pensions for the people in Europe. We need more funded pensions, not less," she said.

> *"We are convinced that efficient multi-pillar pension systems are a key element in order to provide good, adequate and sustainable pensions for the people of Europe"*

Christie to reverse $1.6bn pension cut

JUDGE RULES THE NJ GOV. MUST FIND OTHER SOURCES OF REVENUE

Written by: Lauren Weymouth

A New Jersey Judge has ordered Gov. Chris Christie to reverse a $1.57bn cut he has made to the New Jersey public pension system, forcing the presidential candidate to find new sources of revenue.

The ruling from Mercer County Superior Court Judge Mary Jacobson came after Christie had proposed last year to try and plug a $2.7bn revenue shortfall.

Jacobson said New Jersey could not go back on its obligations to teachers, firefighters and police who sued the governor and state legislature, which is controlled by Democrats. "The court cannot allow the State to 'simply walk away from its financial obligations', especially when those obligations were the State's own creation," Jacobson said.

Although New Jersey's projected budget shortfall was 'staggering', the court said the statute failed to adequately explain why the cuts were reasonable.

According to *Reuters*, Christie spokesman Michael Drewniak said the governor intended to appeal. "The Governor will continue to work on a practical solution to New Jersey's pension and health benefits problems while he appeals this decision to a higher court, where we are confident the judgment of New Jersey's elected officials will be vindicated," Drewniak said in a statement.

Malaysian pension fund first to invest in Japanese real estate

PUBLIC PENSION FUND INVESTS IN PROPERTY WORTH 14BN YEN ($116M)

Written by: Lauren Weymouth

Malaysia's Employees Provident Fund is to become the first public pension fund in Asia to invest in Japanese real estate.

According to the *Asian Review*, the fund spent roughly 14bn yen on acquiring five logistics facilities owned by trading house Mitsubishi Corporation.

Mitsubishi subsidiary Diamond Realty Management will manage the properties.

While the facilities are around 20 years old and therefore command lower rents than new properties, demand is still brisk due to their favourable locations, the *Asian Review* said.

Yields on the properties are expected to come to around 10 per cent, higher than the average for privately placed REITs. The Employees Provident Fund plans to acquire similar properties in the Tokyo area and major regional cities.

The fund is one of the world's 10 largest public pension funds, managing some 20trn yen in assets.

News in brief

■ The **Alternative Investment Management Association** (AIMA) and **CAIA Association** have together published a series of educational papers about hedge funds for pension fund trustees. *The Way Ahead: Helping trustees navigate the hedge fund sector* sets out to give practical guidance about how existing investors have managed issues and challenges associated with their hedge fund investments as well as detailing the advantages of allocating to hedge funds.

■ The Swiss investment fund market reached a 'new high' at the end of 2014, jumping up by CHF 114bn (€114.50bn) over the year to CHF 865bn (€869bn). Statistics compiled for the **Swiss Funds and Asset Management Association (SFAMA)** found the volume of assets entrusted by investors in Switzerland to the fund industry increased by 15 per cent over the year from CHF 750.2bn (€753.50bn) the year before.

■ Net sales of UCITS fell to €27bn in November 2014, down from €44bn the month before, according to the **European Fund and Asset Management Association**. EFAMA said the fall came despite increased net sales of long-term funds during the month and equity fund net sales returning to "positive territory".

■ The total cost of pension liabilities reached €45.7bn in 2013. The cost of pensions for retired EU civil servants and MEPs has increased by 7.3 per cent this year, standing at €1.66bn. Results published in 2012 revealed the average annual pension paid out to an EU retiree is €51,000 each year.

People on the move...

The latest news and moves from people within the European pensions industry

If you have any appointments to announce please contact lauren.weymouth@europeanpensions.net

STEPHANIE OUWENDIJK

Franklin Templeton Investments has appointed Stephanie Ouwendijk as vice president and portfolio manager. She joins the emerging markets debt opportunities team. She joins the firm from Ashmore Group where she served as fund manager since June 2010. Most recently, Ouwendijk was part of a team responsible for external debt and blended debt funds, and in particular was responsible for CEE and Africa sovereign and quasi-sovereign credits.

THÉODORE ECONOMOU

Lombard Odier Investment Managers has appointed Théodore Economou as chief investment officer. He most recently served as CEO and chief investment officer of the CERN pension fund, where over five years he initiated a risk-based approach that came to be known as the CERN Model. Economou will be based in Geneva and build on a similar approach.

MICHAEL HUBER

Michael Huber has joined **Invesco PowerShares** as business development director for Germany and Austria. In this newly created role, Huber will be responsible for driving business development in Germany and Austria, which are both key expansion markets for Invesco PowerShares. Previously, he covered institutional clients for Assenagon S.A.

DON EZRA

Don Ezra has joined the advisory board of **Avida International.** Ezra recently retired as co-chair, global consulting for Russell Investments. He is a fellow of the American Savings Education Council and is a member of advisory board of the World Pension Summit. He received EBRI's Lillywhite Award in 2004 for extraordinary contributions to Americans' economic security.

RUDYARD EKINDI

Unigestion has appointed Rudyard Ekindi as head of investment solutions within its equity team. Based in Geneva he will be tasked with ensuring a full understanding of the investment needs of Unigestion's client base and developing the asset manager's product solutions in line with and tailored to these specific requirements. Rudyard worked at the UK's NEST.

MONIQUE DIAZ

Monique Diaz has been appointed global head of compliance at **AXA Investment Managers**. Based in Paris, Monique will be responsible for AXA IM's compliance teams across the globe. Her role is to further enhance compliance at a global level and ensure that the business continues to be fully aligned with its framework of standards and regulations.

CRISTINA BELOTTI

Societe Generale Securities Services in Italy has appointed Cristina Belotti as head of financial institutions and brokers. Previously sales & relationship manager and head of TARGET2-Securities Products for SGSS, she joins the global financial institutions and brokers team and will be based in Milan. Belotti is a graduate of the Communication and Economics Business School at the University of Modena and Reggio Emilia.

NAOKI KAMIYAMA

Nikko Asset Management has appointed Naoki Kamiyama as chief strategist. As a veteran strategist with 30 years of experience in the securities and asset management industries, Kamiyama has developed a strong reputation among Japanese and non-Japanese institutional investors and has ranked highly in investors' polls of analysts.

KOON CHOW

Union Bancaire Privée (UBP) has appointed Koon Chow as senior macro and foreign exchange strategist in its emerging markets fixed Income team. Chow will run sovereign and FX research and provide trade ideas for the bank's sovereign and local currency strategies. Chow joins UBP from Barclays, where he was a managing director, heading up emerging markets strategy.

PAUL SMITH

Paul Smith has been named president and CEO of the **CFA Institute.**
He has more than 30 years of leadership experience in the asset management industry. Smith joined Bank of Bermuda in Hong Kong as Asia head of securities services in 1996. After HSBC's acquisition of the bank in 2004, he served as global head of securities services and global head of alternative funds administration based in New York.

DEBORAH WINSHEL

BlackRock has appointed Deborah Winshel as managing director and global head of impact investing. She joins the firm with a distinguished career in non-profit management and venture philanthropy, during which she took an active role in shaping charitable giving programs while defining and measuring successes based on the programmes' lasting effects.

PensionsEurope

Striking a balance

THOMAS MONTCOURRIER EXPLORES THE DIFFICULTIES IN IMPLEMENTING EIOPA'S PROPOSED HOLISTIC BALANCE SHEET

THE HBS IMPLEMENTATION IS EXPECTED TO BE VERY COSTLY AND IT IS DOUBTFUL WHETHER THE POTENTIAL BENEFITS WILL OUTWEIGH THOSE COSTS

On 13 October 2014, EIOPA published on its own initiative a consultation paper on further work for solvency of IORPs – the so-called Holistic Balance Sheet (HBS) - together with a mapping exercise. According to EIOPA, the aim of the holistic balance sheet is to create a common tool for a European prudential framework, while taking into account the diversity in national occupational pension systems. In the first part of the paper, EIOPA is consulting on definitions behind the benefit-reduction mechanisms, discretionary decision-making processes, sponsor support and contract boundaries. In a second part EIOPA is consulting the European pension sector to define how any Holistic Balance Sheet supervisory frameworks could work in practice.

The HBS is not suitable as a regulatory instrument at EU level

The consultation goes much further than previous proposals in terms of allowing flexible implementation by national supervisors, for example with regards to valuation of sponsor support. However, this undermines the purpose of the whole project, which was originally intended to allow greater comparability of pension schemes across Europe.

In addition, the parts of the consultation which are intellectually coherent are impossible for all IORPs to comply with given their limited resources, while where simplifications have been introduced, the appropriateness of those simplified heuristics and the chosen parameters are doubtful and thus the intended goal of comparability of results is highly questionable. This illustrates the dilemma of the HBS: to get the HBS workable, simplifications are needed that challenge the whole approach.

Finally, the HBS implementation is expected to be very costly and it is doubtful whether the potential benefits will outweigh those costs. The costs will ultimately be borne by IORPs' members and beneficiaries as well as sponsoring undertakings. This is particularly worrisome in times where the European Union is pushing to enhance long-term and sustainable investments.

Inadequate use for capital requirements

The combination of the HBS and solvency capital requirements raises serious conceptual issues. Indeed, the HBS shows the current market value of all conditional and unconditional pension promises (assuming there is a complete market, which is not the case), and the way in which these promises are backed by current assets and conditional future payments (or possible benefit reductions). As capital requirements are neither part of the pension promise nor of the financing of this promise, there is no place for such requirements in the HBS.

Next to the fact that the HBS concept is inconsistent with the capital requirements, it is also inconsistent with a recovery plan. Calculating the HBS requires including all extra possible future funding like extra sponsor support and instruments such as benefits cuts. If the HBS does not balance, there is no further recovery plan possible, since all security instruments will be already included in the HBS. The HBS is a 'take it or leave it' deal that gives only place for the supervisor to suggest adjustments in the agreement or the recovery mechanisms.

In addition to these fundamental problems, the HBS also implies severe practical issues. The first *EIOPA Quantitative Impact Study* in 2012 has shown that IORPs faced great difficulties in providing accurate numbers when calculating the HBS. This is due to the unavailability of necessary data and the complexity of the methods to use. It makes the HBS very sensitive for model and parameter assumptions, which can result in the valuation of HBS to change by tens of percentage points depending on the assumptions used.

Use for risk management?

The HBS might possibly be used as an instrument for risk management to obtain more insights in relative risks of the balance sheet, but other less costly methods would better achieve this goal. It will never be possible to use the HBS as the sole instrument for risk management as other instruments, which consist of some sort of solvency projection, will always be needed. If such instruments are available, there is little additional added value of also using the HBS, especially given the costs and the complexity of the information that the HBS provides.

Inadequate use as a transparency tool

The HBS is hard to use for transparency purposes towards members and beneficiaries because the information provided by the HBS is not the information that scheme members need, understand or expect. The current market price of option values shown on the HBS are not forward looking and as the participant cannot trade this option, this value is hardly informative.

During the spring 2015, EIOPA will test the outcomes of the consultation in a second Quantitative Impact Assessment but given the questionable cost benefit analysis of the HBS, the introduction of the HBS should not be seen as the only possibility and alternatives should be discussed.

■ **Written by Thomas Montcourrier, economic adviser, PensionsEurope**

Diary dates 2015

The latest events occurring across the European pensions space

IAPF ANNUAL INVESTMENT CONFERENCE 2015
26 March 2015
Dublin, Ireland
iapf.ie/events/

EUROPEAN PENSIONS AND INVESTMENTS SUMMIT 2015
8-10 June 2015
Fairmont Le Montreux Palace
epi-summit.com

EUROPEAN PENSIONS AWARDS 2015
25 June 2015
Grosvenor Hotel, Park Lane
London
europeanpensions.net/awards

Not to miss...

INVESTORS' FORUM
18-19 March 2015
Hotel President Wilson, Geneva, Switzerland
evca.eu/Content/Microsites/investorsforum2015

DB INVESTMENT HALF DAY SEMINAR 2015
26 March 2015
The IOD Hub, City of London
www.europeanpensions.net/ep/events

THE PENSIONS AGE SPRING CONFERENCE 2015
16 April 2015
Hilton London, Tower Bridge
www.europeanpensions.net/ep/events

IAPF ANNUAL DC CONFERENCE
14 May 2015
The Print Works Dublin Castle, Dublin, Ireland
www.iapf.ie/events/event

If you have any European pensions events to promote, please contact lauren.weymouth@europeanpensions.net

OUTLOOK

New year, new challenges

David Adams **explores the issues facing pension funds across Europe in 2015**

WRITTEN BY DAVID ADAMS, A FREELANCE JOURNALIST

The first challenge every pension fund across Europe faces in 2015 is the prevailing economic climate. Like all investors, pension funds must hope for greater growth this year, yet the €1.1 trillion quantitative easing (QE) programme being implemented by the European Central Bank (ECB); and the ongoing QE programme in the UK, will push historically low bond yields even lower. That will surely mean a continuation of the trend for defined benefit (DB) schemes to conduct de-risking exercises, particularly in countries including the UK, the Netherlands, Switzerland and Ireland, Mercer's senior associate in the retirement practice Anne Bennett suggests.

IORP II

Every scheme in Europe will also be affected by the seemingly endless procession of regulatory and legislative changes at national and (for member states) EU level. The headline item in this area for 2015 – even though it will almost certainly not become law anywhere this year – is the ongoing review of the 2003 Institutions for Occupational Retirement Provision (IORP) Directive.

IORP II could make life even harder for DB pension funds by aligning the directive much more closely with the Solvency II regulation that governs the insurance industry, through the use of a Holistic Balance Sheet (HBS).

Following criticism from interested parties including the governments of the UK, the Netherlands, Germany, Ireland and Belgium, European Commissioner for the Internal Market, Michel Barnier, published a new version of the proposed new IORP Directive in March 2014, which was then revised by the EU Council in the autumn of 2014, with a fourth compromise text published in late November. This contained revisions including additional flexibility that enabled the speed and extent of implementation to be determined by national regulators.

The European Parliament will start scrutinising the directive text in March – a process that will begin with the original text, not the fourth compromise text. The parliament should then issue a report at the start of the summer, with a plenary to follow in the autumn and a trialogue (meetings between the parliament, the EU Council and the European Commission to agree amendments) around the end of the year.

In the meantime, pension funds must develop plans that would enable compliance with the directive, whatever form it might finally take. And the European Insurance and Occupational Pensions Authority (EIOPA), the EU supervisory authority for the pensions industry, will begin quantitative impact and stress testing for IORPs this summer.

EIOPA continues to advocate use of the HBS, despite objections from national regulatory authorities; and their representative organisation PensionsEurope. As its response to EIOPA's consultation on IORP II puts it, "[The HBS] does not recognise the specificities of national pension schemes sufficiently... We would like to reiterate in this respect that pensions fall under the subsidiarity principle and under national social and labour law."

PensionsEurope and other opponents of the HBS suggest it would also have adverse effects on economic growth across the continent, as funding rules would impair the ability of funds to invest in long term assets such as national infrastructure projects. "For most pension schemes it is a disproportionate waste of time and cost," Lane Clark Peacock head of corporate practice Alex Waite says.

Whatever the outcome of the parliament's deliberations, Waite believes it will be important for schemes to start bringing a 'Solvency II-like' element into strategy. "If you are already in that mindset then when the new rules come in it won't matter to you," he says. But if dire warnings about the impact of the HBS are correct, such a shift will still require a lot of cost and effort.

"The criticism we have seen has been made because we would make it transparent that something like a low interest rate is a problem and is creating a deficit," EIOPA coordinator of pensions policy Sandra Hack responds. "[The HBS] would just make it more transparent. It's a tool for risk management." She says EIOPA will look carefully at responses to its consultation on IORPs II. "We expect to go back to the European Commission with our advice on this by the end of the year," Hack adds.

Capital Markets Union

Another regulatory change that will bear fruit in the years ahead but may prey on the minds of at least some pension fund administrators, trustees or sponsors during 2015 is the European Commission's Capital Markets Union (CMU) project, which launched in January. The aim of the CMU is to create a single market for capital across all 28 member states by removing barriers to cross-border investment. A green paper was adopted in February to provide a framework for consultation.

Hack says some of the work EIOPA is doing in relation to CMU relates to the development of personal pension products that might be sold across the EU under the new regime. These could be bought by individuals from banks, asset managers or life insurers. "If we could make this kind of individual investment by consumers more attractive, the pension funds, banks and insurers issuing these products would have more capital; and this could benefit investments in infrastructure and other long-term investments," she explains. "This is something we will see people discussing this year."

National pension systems

Some European countries will experience major upheaval in their national pension systems during 2015. In the UK, the pensions freedoms announced by Chancellor of the Exchequer George Osborne in his 2014 Budget will come into force. From April, members of DC schemes in the UK aged 55 or over will be able to access their whole pension pot if they wish. There are significant concerns about the readiness of some pension providers to comply with such requests and about the fitness for purpose of 'guidance' provisions being introduced to give anyone considering exercising these freedoms a free consultation to discuss their options. Further knock-on effects on the broader UK pensions system may become visible by the end of the year.

Other potentially significant national developments include the German government's plan to create a legal framework for 'Dutch-style' industry-wide pension funds. This will entail the introduction of DC-like pensions into the second pillar of the German system for the first time, although a minimum guarantee will be made to members (by the pension fund rather than the individual member's employer).

The trend for state benefits to be cut and state retirement ages increased remains visible across Europe, while some politicians, in power, or potentially set to take power during 2015 in countries including the UK, the Netherlands, Spain and France, are also considering how they might tighten taxation on pensions. Where such changes are implemented there will probably be additional implications for the design and investment strategies of occupational and private pensions.

More radical changes are afoot in some central and eastern European countries. The Bulgarian government is following a lead taken by Poland in 2013 by effectively part-nationalising private pension provision, allowing employees to transfer pension savings accrued in second pillar pension funds into the public pay-as-you-go system. PensionsEurope has expressed concerns that employees are being forced to choose between two completely different systems of pension provision; and this development undermines the ability of funded schemes to contribute to the Bulgarian economy.

However, other countries in the same region are not following this trend, such as Romania, where the national Private Pension Association is predicting assets held in second pillar schemes to grow by 30 per cent during 2015, as the second pillar system launched in 2008 matures.

Such regional variations are an indication of the extent to which Europe remains an intriguing mixture of regimes, collectively likely to continue to frustrate attempts at regulatory harmonisation; and each throwing up challenges for those tasked with managing them.

One consolation for those in that position who felt overworked, or were weighed down by concerns about the future during 2014 was that most, to some extent, succeeded in their most fundamental purpose. As PensionsEurope CEO and secretary general Matti Leppälä puts it: "There are so many uncertainties, politically and economically – but all in all, pension fund investment results have been quite good." It must be hoped that this trend continues in 2015. ■

REFORM

Looking to the future

As pension sectors throughout Europe go through a period of significant change, Pádraig Floyd **examines the impact of these reforms and how they will shape the future of pension provision**

WRITTEN BY PÁDRAIG FLOYD, A FREELANCE JOURNALIST

In a little over a century, pension provision seems to have done nothing but change and this has accelerated in recent years.

The wonder at the increased length and quality of life of the average European citizen has been checked by the dawning realisation that someone has to foot the bill for populations living longer than the prescribed three score and 10 years.

Greek pensioners have already experienced cuts, but theirs is not the only government to have made radical changes to social security and in particular pension structures.

Retrograde step

A number – largely in the east – have hacked away at the IMF's three pillar pensions structure. In 2011, Hungary withdrew its second pillar – or workplace – pensions, while in 2012 Poland, Slovakia and Romania all reduced contributions to theirs. The new government of the Czech Republic – which only recently introduced a second pillar – has plans to scrap this from 2016.

Though this will buy some breathing space for governments in extremis, this approach is merely borrowing from Peter to pay Paul and has been roundly criticised by the IMF.

However, the changes are unlikely to be reversed any time soon, says the OECD policy division's Andrew Reilly.

"Once these things have been put in place, they strengthen the finances and payment for the state component.

"Any future pensions reform in these countries is also unlikely to be another mandatory scheme, but placed on an entirely voluntary basis."

Abandoning a second pillar also flies in the face of what most OECD – and European – countries in particular are trying to do, says Robeco director of European pensions Jacqueline Lommen.

"There is an emphasis on capital-funded pension provision – it is no longer focused on pay as you go – by independent pension entities.

"This is not only in the UK and Netherlands where it is very obvious, but in many countries."

Countries with a high reliance on the first pillar have been introducing defined contribution schemes of varying degrees in recent years for the same reasons employers have abandoned defined benefit.

Falling interest rates, increased longevity and falling birth rates make the ratio for funding an ageing population something of a nightmare.

As a result, the EU will be a catalyst for change and reform, says Lommen. But as this shift towards DC takes place, so the EU is increasingly keen to protect the individual saver from the increased investment risk.

Consider the alternatives

To mitigate this risk, some employers – and their government agencies – continue to assess alternatives, says J.P. Morgan Asset Management European head of the strategy group Paul Sweeting.

Defined ambition evolved from a DB mindset and has attracted support from the UK's pensions minister, Steve Webb.

Dynamic elements such as conditional indexation (so there is only a pension increase if there's enough money) or retirement ages that change in line with longevity expectations are built in to the model.

A further move away from DB is collective defined contribution (CDC), says Sweeting, which essentially behaves like DB pension schemes, but assumes there is no sponsor there to pick up the tab. So, if you have a deficit, the response is to put in more money or reduce benefits.

The income builder approach, as used in Denmark for instance, might also gain traction, he says, as contributions are used to buy slices of deferred annuity. This still fixes the contributions, but provides a guarantee on income levels for individuals.

However, Sweeting advises against any single approach being seen as the panacea to the pensions crisis.

"It is important to look at the systems in which they sit. Both DA and CDC are essentially occupational systems as they're related to employment to an extent. But it needs to be understood in terms of what other income from there is the state or savings, because that is where every pensions approach has to sit."

Lommen too rejects the notion that a single model is worth discovering and argues that DC will be the future model, so it is time to change the approach to investments in order to deliver what she calls smart DC.

"It's a far more sophisticated way of lifecycle investing, which includes human capital theories, and goes beyond target date lifecycle funds. It applies return and matching concepts and – especially in the Netherlands – we are delivering this smart DC for several years via the new PPI pension institutions."

This model of course is reliant on large independent pension structures, but another interesting innovation is longevity pooling. Not via some sophisticated investment strategy or insurance instrument, but in a good old fashioned annuity pool.

"One of the ideas we are looking at would mean if people die by the age of 70 or 75, the assets accrued or remaining in their individual account will not go to their dependents, but remain in the pension provider and be redistributed among the other members that survive," says Lommen.

Don't fence me in

Of course, this isn't the only novel approach. Cross-border pensions have been touted as a solution to the woes of those larger organisations with multiple operations who struggle to run schemes in each jurisdiction.

Sweeting concedes the argument has merit, but limited practical application, as it may be as difficult as anything it replaces and diseconomies of scale may become apparent.

"Even then, is a cross-border scheme the right approach, or is it best instead to just settle for some sort of common investment fund where the individual schemes buy units in that fund, and it's the fund that achieves the economies of scale," he asks.

However, Brussels-based Aon Hewitt partner and leader of cross-border pensions, Thierry Verkest, is adamant that cross-border pensions is a concept that works, despite all the doubts and naysaying.

Existing cross-border pension funds are working successfully, says Verkest, and continue to expand with new countries joining. And he should know – he's set up a few of them, with more in the pipeline.

The reason why they want them is simple, he says. They get corporate oversight and much better control of their pensions – at least in Europe – and that is what they're looking for. They can adopt a more flexible funding regime through regulatory arbitrage, and possibly even make cash savings.

"For multinational companies, at least, with multiple operations in Europe, the way forward could well be to set up this kind of cross-border pension fund," says Verkest.

This too is not easy, nor quick, he admits. It may take 10 or even 20 years, but the early adopters have convinced others to begin their own builds.

Future of reform

While Verkest is currently working directly with the commission on a cross-border scheme for all its researchers, the notion of a cross-border private pension product is a non-starter. Working within the IORP Directive is a slow burn, but it makes no provision for an individual product.

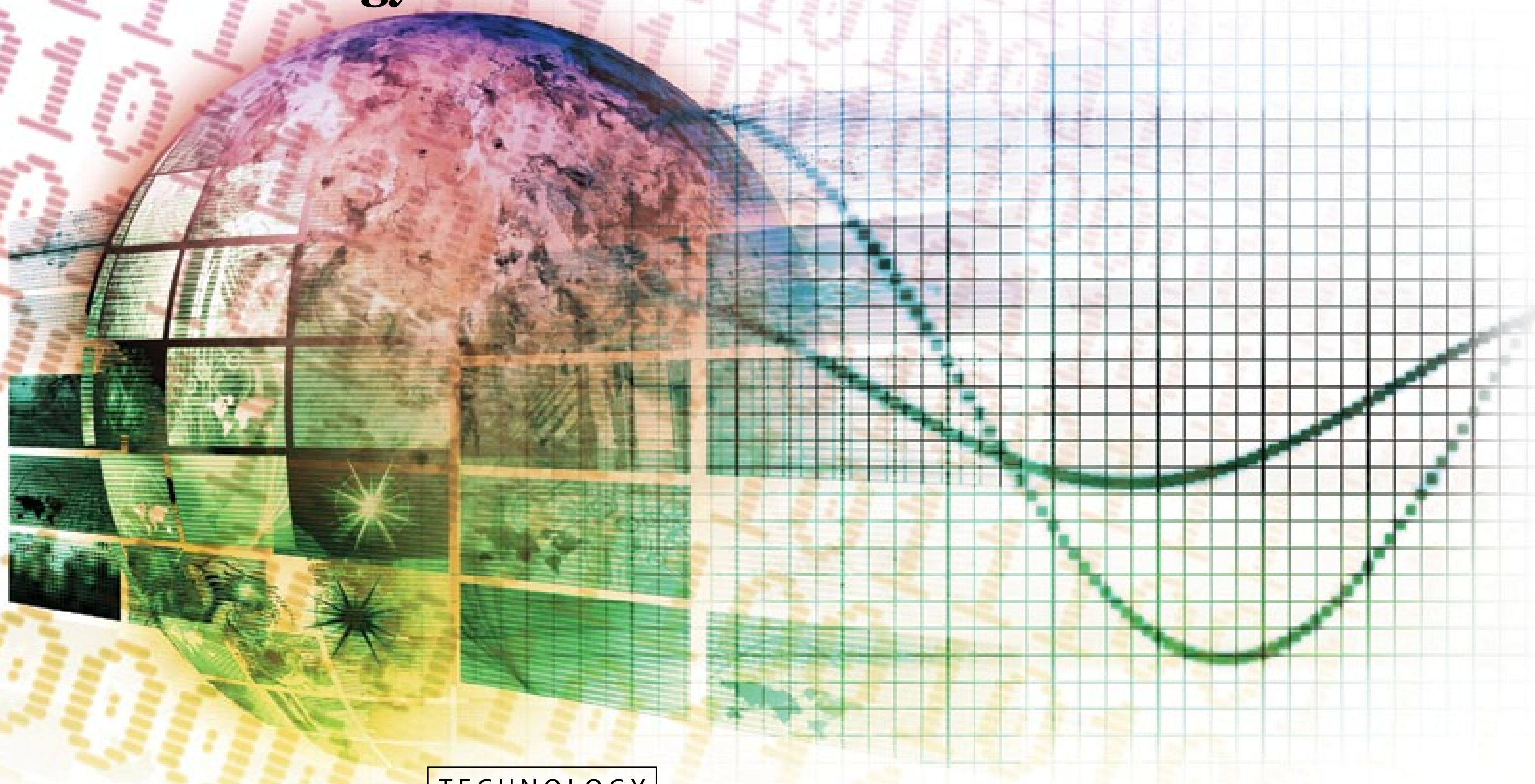
Lommen maintains the EU will drive pensions reform within Europe and rejects the often popular concept that it interferes.

She says the work of EIOPA is important and its role could – and should – increase: "EIOPA is key and they play a great role, which is increasingly acknowledged by member states, that they should be closely – and proactively – involved in Frankfurt."

Sweeting is somewhat pessimistic about the pace of reform. And despite the obvious dangers of doing nothing, reform will only come when the impact on the country's credit rating becomes unavoidable.

"When the risk of providing pensions and the cost of providing pensions to the ageing population become so great that something needs to be done or a country will slip from even being investment-grade. That's what it will take, and in those cases, they will have to start cutting benefits."

The consequence may be a period of intergenerational strife as the young see their legacy undermined and the old resist changes that will affect their incomes. ■



TECHNOLOGY

Access all areas

Adam Cadle explores the current technology trends and developments in the European pension fund space

WRITTEN BY ADAM CADLE

The pensions space across Europe is developing at a phenomenal rate. Regulation changes in both the defined contribution and defined benefit arenas are keeping pension funds constantly on their toes, investment strategies and techniques are becoming more tailored and attitudes to risk management are evolving.

It is within the technology arena however where there has been significant notable developments. Indeed, RiskFirst's managing director Matthew Seymour believes there is room for more progress. "The development and adoption of technology by the pensions industry has gathered pace across Europe," he explains. By comparison to other areas of financial services, it could be going faster, which would be to its own benefit, but it is going in the right direction, with schemes and consultants increasingly looking to technology to help them manage risk pension risk in a more dynamic and operationally efficient way."

Member communication, data regulation and advice

Three huge areas where technology is playing a major role are around member communications, the ways consultants are giving fund and investment advice to sponsors and trustees across Europe, and data quality. "It has been transformational," LCP's head of corporate consulting Alex Waite says. "Real time consulting is now being used, where we are sitting down in meetings with companies or trustees and conducting 'what if' scenarios. We can provide answers to the questions in meetings using the maths built into funding tools and it is about doing proper actuarial valuations at the press of a button. When I started in the pensions industry around 25 years ago, people dreamt of being able to do that and now we can."

Looking at member communications, the European pension fund space has now reached a stage whereby communication can be tailored to the individual. "As a scheme member you are receiving something that is highly bespoke to your personal situation and is more relevant," Waite notes. Furthermore, pension fund managers, trustees and consultants have now jumped onto the social media wagon to such an extent that online communication and Twitter usage is now booming.

Emphasis on data quality is an area that has also intensified, particularly in the UK, and the need for technology here should not be underestimated. The Pensions Regulator in the UK has issued numerous publications on the need for common and conditional data standards to be as high as possible. Speaking at a *Pensions Age* data and technology seminar in London last year, ITM director Dan Hockley said: “Administrators will eventually become a thing of the past as schemes begin investing in data and admin technology such as cloud services leading to savings and cost reductions.” He added that automatic processes will be needed more and more.

Risk

Technology has and continues to be essential in the risk spectrum as well. Platforms such as RiskFirst’s PFaroe are being used for risk management in the DB space.

“The online application (PFaroe) provides all of the analytics required to manage the risk of a scheme (assets, liabilities and risk), joined-up and using consistent underlying market data, easily accessible on-demand,” Seymour states.

“Though a number of DB pension plans have closed, the plans and the risk attached to them remains,” he adds.

Ortec Finance managing director Lucas Vermeulen emphasises the distinction between testing dynamic strategies to react to developments in the risky environment to the more static risk management used by risk vendors and managers. Speaking of the dynamic strategies, Vermeulen compares the software to a ‘flight simulator’ for trustees.

“It enables them to develop and test strategies and to understand what policies work, under what circumstances, and why. In addition we offer top down performance attribution to be able to analyse if the strategy is still on track,” he explains.

Pension funds and climate technology

A slightly different technology trend has been seen in Denmark. The Danish Climate Fund offers risk capital and advice for climate projects in developing countries, the growth markets in Asia, Africa, Latin America and parts of Europe. Through private funding amounting to DKK 774 million from pension funds, PensionDanmark and PKA, the fund invests in projects promoting the transfer of Danish climate technology. Investment will primarily be in technologies aimed at reducing greenhouse emissions in all countries included in the OECD’s Development Assistance Committee. Projects to be considered include solar, hydro and wind power plants, as well as urban transport construction, biogas plants and projects that can improve energy efficiency, thereby cutting emissions by at least 20 per cent.

THE DEVELOPMENT AND ADOPTION OF TECHNOLOGY BY THE PENSIONS INDUSTRY HAS GATHERED PACE ACROSS EUROPE

ATP Pension Fund has invested in renewable energy infrastructure and technology, such as solar wind and hydro, as well as emerging technologies, such as biofuels and biomass for a long time. ATP invested DK 600 million in renewable and has committed DK 2.2 million to concrete assets and over DK 2 billion of equity in companies that are related to the renewable and clean energy sector.

Indeed an OECD paper entitled *The Role of Pension Funds in Financing Green Growth Initiatives* highlights the role of European pension funds in financing green growth initiatives and the use of technology for this.

“It is estimated that transitioning to a low-carbon, and climate resilient economy, and more broadly ‘greening growth’ over the next 20 years to 2030 will require significant investment and consequently private sources of capital on a much larger scale than previously,” it reads. “With their $28 trillion in assets, pension funds - along with other institutional investors - potentially have an important role to play in financing such green growth initiatives.”

Outlook

It is certainly safe to say technology will continue to develop across Europe to help ease the load on pension fund management. Vermeulen says in the context of the pension freedom in the UK, the challenge is to give highly cost-effective, yet decent advice to DC members who now face more difficult decisions than ever before. “The only viable way is to use technology,” he concludes. “The question is who will be able and willing to provide this.”

Looking to the Dutch arena, with the collective defined contribution market developing and expanding, technology will have to keep pace with these changes. With the natural move towards scale that has been seen in the Dutch and Danish markets, technology and funding tools have had to and will continue to adapt to serve the pension funds’ needs. ■

LONGEVITY

Age is not just a number

Longevity is increasing at a rapid rate and subsequently, so are pensioner liabilities. Lauren Weymouth **looks at how pension funds across Europe are stepping up to better manage this risk**

WRITTEN BY LAUREN WEYMOUTH

Thanks to science, medicine, and a number of lifestyle improvements to have taken place over the past 50 years, we are living longer. We are now heading towards an average life expectancy of between 90 and 95. Furthermore, figures released by the Office for National Statistics this year show that by 2055, people born in the UK could expect to live until at least 100.

This is fantastic news, of course. For pension funds, however, a surge in longevity means two things: bigger liabilities and bigger deficits. Low growth, low interest rates and low returns on investments alongside a rapidly ageing membership means Europe's pension funds now face the constant challenge of managing – and often removing – some of this risk to ultimately increase assets and lower deficits.

As PensionsEurope economic adviser Thomas Montcourrier says, while liabilities have seen sharp increases, interest rates have considerably fallen. "Lower interest rates result in lower discount rates, giving a relatively higher weight to the future," Montcourrier says. "As longevity risk is back-loaded, reductions in interest rates increase the impact of longevity risk on the net present value of annuity payments," he adds.

However, Pension Insurance Corporation head of business origination Jay Shah argues that other risks, such as failure to adequately hedge inflation risk and the mismatch between assets and liabilities are "arguably far greater". "Holistic de-risking strategies implemented earlier would certainly have altered the DB landscape and would likely mean that far fewer of these schemes would have been closed," Shah says.

So, with all of this risk amidst a struggling economic background, pension funds have some serious decisions to make. According to Montcourrier, there are three key things pension funds across Europe are currently doing to better manage longevity risk. Firstly, he says, they are looking to regularly update longevity models with new international data from the OECD, allowing for expected future increases in life expectancy. Secondly, they are using longevity indices, and thirdly, they are using conservative yield curves for the valuation of pension liabilities.

Although these are positive steps towards keeping longevity risk in check, Montcourrier says there are two specific approaches funds need to take to manage risk entirely. "The first one – as can be seen in the Netherlands – is to make the pension promise more flexible by shifting longevity risk to the individuals (defined ambition)," he says. "The second, which is more prominent in the UK, is hedging longevity risk through insurances or the market."

In the UK, hedging longevity is one of the most common methods of transferring longevity risk and over the past two years, the buy-in and buyout market has doubled, with 20 per cent of FTSE 100 companies with UK pension plans having completed a transaction. Innovation was a key feature of the longevity swap market in 2014 in particular, when more than more than £22 billion of liabilities were hedged using the trustee or sponsor-owned insurance companies that transact direct with reinsurers.

LCP partner Emma Watkins says record insurer capacity resulting from the Budget statement in the UK will help to maintain competitive pricing as demand trends upwards. "The positive outlook is reinforced by strong reinsurer appetite for longevity risk, which is benefiting the pricing of buy-ins, buyouts and longevity swaps" she says.

"Competitive pricing is set to remain as insurers continue to be successful in sourcing attractive long-term investments. Several potential new insurers are set to join the market. This will further increase competition in 2015 providing extra confidence in the accuracy of our prediction that buy-in and buyout volumes are on course to remain in excess of £10 billion a year," Watkins adds.

For the rest of Europe, however, insuring longevity hasn't featured quite so highly on the list. A huge part of this problem, as Aon Hewitt partner Matt Wilmington highlights, is that most EU countries are yet to actually recognise that people are living longer.

"The UK has done a good job of this – they have introduced a lot more sophistication and realism and we are now in a position where we feel fairly confident when talking about the fact people are living longer," Wilmington says.

"However, other countries such as Germany, Switzerland and the Netherlands are lagging in terms of their thinking. Until very recently, a lot of them were vastly underestimating how long people were living when they were doing their funding and accounting calculations, but fortunately that it is now starting to change in some countries."

Wilmington says the Netherlands in particular are now starting to think about more sophisticated projections and starting to get a better idea of how long people are living. "Some countries, like Switzerland, aren't getting a good measure on that and aren't measuring how long people are living for properly, so it is very important people start recognising it is a problem, before they can possibly fix it," he says.

In order to assess such life expectancies, one of the most common models used by pension funds is the postcode model. This model is used to more accurately predict how long people are living by using a members' postcode to analyse the average life expectancy for their location. At present, this is a model frequently used by almost all pension funds in the UK.

However, JLT Employee Benefits director Charles Cowling says the model hasn't had much use outside of the UK and Netherlands, which he says is because "they are the two countries with a large volume of DB schemes and who understand members' mortality is critical to their business more so than others".

Although the postcode model helps pension funds to understand more about their liabilities, it doesn't – unlike longevity swaps/buy-ins and buyouts – actually manage the risk, it just helps to acknowledge it. According to Cowling, until more pension funds across all EU member states recognise longevity as a problem, it is unlikely many new models will actually be implemented.

Going forward, however, Montcourrier explains how there is likely to be some growth among collective defined contribution schemes, such as the Dutch model, where instead of managing the risk individually, a group of pension schemes will share it collectively.

However, he adds there are also new problems associated with collective schemes, such as an unequal distribution of costs and benefits as risks and value are transferred between current and future generations, male and female, the sick and healthy.

"It is also not geared to heterogeneous participants as most collective schemes impose identical contribution and indexation rules for. In addition, consolidation of pension funds also improves cost efficiency due to economies of scale," he adds.

Cowling agrees that while CDC is a good idea for sharing risk and that in theory, it could potentially solve or ease the longevity problem, it won't work in practice. Instead, he says, "all it will do is accelerate the move to DC".

Life expectancy is said to be increasing by six hours a day. At such an astonishing rate, it is imperative pension funds begin to fully assess the accounting for their liabilities, making sure all data is up to date and an ageing member-ship is taken into consideration. While the UK has progressed in this area (followed closely by the Netherlands), it appears many EU member states still have a lot of work to do.

"[Pension funds] need to look to remove longevity risk as part of an overall de-risking strategy, and not in isolation," Shah says. "If they go down the longevity swap route, they should make sure they don't find themselves locked into a complicated-to-administer arrangement that precludes the possibility of further de-risking," Shah says.

It is undeniable that people are ageing and it is great news that people are living longer, fuller lives. But in order for members to fund the retirement they deserve, pension funds have to accept longevity as a challenge that needs to be tackled. The UK and the Netherlands may have jumped to accept the task, but for the rest of Europe, there is still a long way to go. ■

INTERVIEW

Passive investment, active ownership

For KLP, Norway's largest pension fund, SRI considerations are vital to all its investment decisions. Laura Blows **speaks to department manager Jeanett Bergan about how KLP implements responsible investing**

WRITTEN BY LAURA BLOWS

Why is SRI important to KLP?

KLP is owned by its customers, which are the local governments and municipalities in Norway, so our values are very much aligned with those of the Norwegian people. Their opinions are important to us. The state health enterprises are among our biggest owners and our typical members are nurses and local government employees. There are approximately 650,000 Norwegians who have their pensions with KLP.

Responsible investment is part of KLP's DNA. We first established guidelines for responsible investments in 1998. These were not very sophisticated, but they created a mandate for further engagement. In 1999, KLP began excluding tobacco products from its investments. Among KLP's owners, the state health enterprises provided the impetus for that decision, given the impact of tobacco on public health.

The second phase of our ethical guidelines occurred in 2000-2001, when KLP joined the UN Global Compact and began excluding companies in violation of international norms. KLP made the first of these exclusions in 2002-03.

We decided from the start that if KLP is going to exclude companies, this must occur through a transparent process. KLP publically names which companies are excluded and why, and exclusions apply to all assets under management, not just to a particular niche fund.

This commitment to transparency creates strong pressure for a systematic and constant process, as KLP's decisions on responsible investment must withstand public scrutiny. We would like to think that these policies helped inspire the subsequently developed Council on Ethics for the Norwegian Government Pension Fund, which publishes divestment decisions, by setting a high bar for transparency.

Have your areas of focus changed over the years with regards to ethical investment?

Our ethical investment strategy has developed in terms of how we monitor, investigate, and document cases. Nevertheless, our fundamental principles are still the same and we are every bit as involved in engaging with companies and evaluating cases as when we started. In terms of the themes involved, of course the areas of focus have changed somewhat over the years – for example, climate change has naturally moved much higher up on the agenda since 1998.

Could you describe your fundamental principles?

We are a passive investor and an active owner. We monitor and engage with companies when necessary, and if we do not reach a satisfactory result, then we exclude the company. We apply this policy to all of KLP's investments across the board.

The areas of exclusion have developed over the years. As the general expectations for corporate responsibility have risen, the issues have become increasingly more challenging. It can be both difficult and fascinating to evaluate whether to exclude a given company for activities that do not fall into clear categories. We have very interesting dialogues with companies on issues that defy easy categorisation, like the environmental implications of shale oil and gas exploration.

We are very specific in stating why we exclude a company. For instance, instead of stating simply that we believe a company is complicit in violations of international law, we exclude a company because they have an oil reconnaissance contract off the coast of Western Sahara, a non-self-governing territory. We are very specific in documenting why a specific case constitutes a violation of KLP's guidelines for responsible investment.

We are also an active owner with respect to voting. We vote our shares in all jurisdictions in which we are able to do so. We let companies know that we are a passive investor and a long-term owner. If we exclude a company, our goal is always to have the company on board again for the long term. That is why, in contrast to many investors, we also engage with excluded companies. We engage in dialogue with them because we want to see a positive change. We also want to be a long-term owner because the excluded company remains part of our benchmark. Among the companies that KLP has excluded and later included are Coca Cola, Toyota, Yahoo! Inc., and several more.

KLP recently moved away from coal investment. Why was that?

We divested from all companies that obtain a minimum of 50 per cent of their revenues from coal-based activities. It is not an absolute limit, so we will likely exclude even more companies under this criterion in the future. The reason for this decision is that coal combustion, at current volumes, is not compatible with reaching the two-degree scenario. KLP did not divest because we think coal is unethical or that those producing coal are doing something wrong, but we want to send an important signal to coal and fossil fuel companies on what we would like to finance for the future and that we have to switch the energy mix. We are moving away from coal investment while simultaneously investing in new renewable energy capacity in developing countries where the alternative very often is coal.

What impact has this had on returns?

We have done an analysis and we know we can exclude coal without hurting the risk/return profile. However, we cannot say the same for the exclusion of all fossil fuels. That is one reason why KLP's decision is limited to coal. In addition, from an environmental perspective, coal is far more CO_2-intensive in terms of energy output and is a major contributor to local pollution. Nevertheless, we realise there is a very big difference between types of coal companies. Some coal plants are very energy efficient and pollute less than others do. We do not claim that our criterion is perfect, but we believe it sends the right signal, which is our overriding aim.

WE HAVE THIS MANTRA THAT NOBODY CAN DO EVERYTHING, BUT EVERYBODY CAN DO SOMETHING. AT KLP, WE TRY TO LIVE BY THAT

How do you respond to concerns that SRI is too costly and difficult to implement, and affects returns?

I'm not persuaded by these concerns. It's a question of scale; everybody can do something. Investors cannot expect perfection, but have a responsibility to do what they can. As a provider of pensions to Norwegian health enterprises and municipalities, we are clear that KLP's foremost social responsibility is to ensure that we manage these assets in a financially sound manner for current and future retirees and mutual fund customers. That does not mean, however, that our customers and owners are indifferent to how these returns are created. We have this mantra that nobody can do everything, but everybody can do something. At KLP, we try to live by that.

Have there been any changes to how KLP implements SRI?

We have a publically available list of companies that we have excluded. It includes companies such as those violating environmental regulations, that produce nuclear weapons or landmines, and tobacco companies. Our list has been public since 2003 and is updated semi-annually in June and December. It is a robust process. We continuously monitor companies, looking at cases and investigating further any indications that a company is violating KLP's responsible investment guidelines. In addition to information from our service provider as well as our own research, we regularly request a second opinion from an expert in the relevant issue area, such as human rights law.

Do you think there is an increasing appetite for pension funds to implement SRI?

There has been increasing demand for SRI over the years and the use of exclusions is the area growing most quickly. The recent sanctions against Russia placed exclusions even more on the radar; as that also needs to be addressed in investments. When you use the synergy between exclusion and active ownership, companies understand that you are serious about your opinions. From our experience, when investors are transparent about the reasons for divesting, even the smallest minority shareholder can exercise power. ■

COUNTRY SPOTLIGHT SWITZERLAND

Keeping things sweet

Swiss pension funds ended 2014 on a high, with the average pension fund fully funded. But how can this success be maintained? Peter Davy **finds out more**

WRITTEN BY PETER DAVY, A FREELANCE JOURNALIST

It's both the best and worst of times for Swiss pension funds. Among the 10 largest pensions markets in the world, despite a population of only eight million, assets reached $823 billion at the end of 2014 according to *Towers Watson's Global Pension Assets Study*.

It is the third successive year of growth for the industry, and Credit Suisse's Pension Fund Index, which tracks the returns of funds for which it acts as custodian, increased 10.7 points to top 150 for the first time, finishing at 152.23 against a base of 100 in the year 2000.

That was the result of positive returns in almost all asset classes over the year, led by foreign and Swiss equities, as well as Swiss bonds and real estate. Credit Suisse calculated the overall yield of funds as 7.73 per cent for the year; Swisscanto's Pension Fund Monitor of 370 funds with assets of CHF 506 billion put returns at 8.3 per cent.

Consequently, it calculates that the asset-weighted funding ratio of private sector funds increased 5.6 percentage points in the year to 115.9 per cent – its highest position since 2004 and almost exactly in line with the 100 per cent funding plus 16 per cent "value fluctuation reserve" targeted by the average Swiss fund to ensure minimum return targets and benefit guarantees.

"As at the end of December, the average pension fund was fully funded according to the investment strategy they've chosen," explains asset manager Swisscanto pension fund expert Heinrich Flückiger.

That's the good news.

The bad news is it's unlikely to last. For a start, the funding ratios funds report can exaggerate their health, according to investment and actuarial consultants PPC Metrics partner Dr Hansruedi Scherer.

Swiss accounting rules allow schemes considerable flexibility in determining the discount rate used to calculate their liabilities. When PPC Metrics did a survey of funds with more than CHF 500 billion in assets it found discount rates used in 2013 ranging from 2 per cent to 4.5 per cent – a "very wide range", says Scherer.

"These official numbers for the coverage ratio are not very reliable to be polite about it," he says.

It calculates an economic funding ratio for its client pension funds using market rates – closer to the 10 year yield on high quality government bonds in most cases. On this measure, many pension funds are still not fully funded.

More importantly, it is difficult to see how it is going to get better.

A volatile time

Swiss funds face some strong headwinds.

Already most have had a more difficult start to the year after the Swiss National Bank (SNB) dropped its peg to the euro, introduced in 2011. Funds operating a currency hedge were partly or wholly immune to the immediate rise in the value of the Swiss Franc (which shot up 30 per cent, before falling) resulting from the central bank's move. However, none will have been immune from the 9 per cent drop in the Swiss stock market, the biggest one-day fall in more than 25 years.

"There is no pension fund in Switzerland that does not have Swiss equities. They were hit," says Swiss consultant Siglo partner Christoph Gort. Like in other countries funds also tend to have a home bias in their equity portfolio.

"That has helped quite a lot over the last few years given that Switzerland performed better than average, but on 15 January it was not really an advantage," he adds.

Towers Watson has estimated that the end of the currency peg wiped out CHF 30 billion of pension fund assets.

Funds also now face the difficulty of what to do now about their currency risk. On the one hand, the value of being hedged is now clear to those who weren't. On the other, the cost of hedging 'exploded' in January, reducing returns up to 3 per cent, according to consultancy c-alm.

That might prove only a short term problem, though, according to another PPCmetrics partner, Dr. Marco Jost.

"It's probably a short-term effect, and hedging costs will come down again when the volatility is out of the market," he says.

Rather the longer-term problem was symbolised by the SNB's other, less remarked upon move that day: cutting interest rates even further into negative territory – to -0.75 per cent for overnight lending to banks from the -0.25 per cent introduced in December.

Negative rates

As Gort notes, 10-year Swiss government bonds yield 0 per cent (at the time of going to press), and peaked at -0.26 per cent. Once the costs of hedging euro government bonds are taken into account, meanwhile, the expected return there is -0.5 per cent. The options are narrowing.

"Imagine a scenario where interest rates go up even moderately in the US. Then US government bonds'

ALREADY MOST HAVE HAD A MORE DIFFICULT START TO THE YEAR AFTER THE SWISS NATIONAL BANK (SNB) DROPPED ITS PEG TO THE EURO

expected return for a Swiss-based investor will also be negative. Think about it – Swiss government bonds giving negative returns; European government bonds giving negative returns; the US flat and potentially negative. That leaves Japan, and do you want to hold Japanese government bonds today?" he says.

"That is probably the biggest long-term challenge – What do you do with your fixed income allocation?"

The answer is not immediately apparent. Some may choose, at least in the short term, to run the currency risk on foreign bonds, says Flückiger. With no inflation-linked bonds in Switzerland there may also be case, with negative interest rates, to look to shorter-term bonds for returns, according to Scherer.

"In typical market conditions you have an illiquidity premium on longer-dated bonds, but with the interest rate curve at the moment it is not clear whether this is really the case because the implied forward rates are so low," he says. "The whole risk return trade-off may have changed."

The answer many come up with is to look to alternatives. However, here policy is again making life difficult.

As Geneva-based consultant, the Pittet Group, chief executive David Pittet explains, Swiss pensions have become increasingly tightly regulated in recent years.

"There has been quite an important shift since 2010 to a more safety-orientated and state controlled system," he says.

THERE HAS BEEN QUITE AN IMPORTANT SHIFT SINCE 2010 TO A MORE SAFETY-ORIENTATED AND STATE CONTROLLED SYSTEM

Two reforms particularly make it challenging to increase allocations to alternative funds.

One is the 2013 decree that meant pensions now must publish the total expense ratios of the funds they invest in, highlighting the higher fees of some alternative managers. The initial draft of the AV2020 pension reform, which will be finalised this year and introduces reforms to both second and first pillars, even suggested introducing a charge cap for alternatives.

More importantly, pensions are limited to investing 15 per cent, and from this year, the investments that fall into the 'alternatives' category have been extended to include assets like senior secured loans, insurance linked securities and perpetual bonds.

"Swiss pension funds are facing a really challenging time and the regulatory environment is not going the right way to help them," says Towers Watson investment consultant Fabien Delessert.

Funds can break the 15 per cent limit as long as they explain their reasons, as some big pensions like the City of Zurich's and Winterthur's already do, but many others are reluctant to do so.

"A lot of pension funds want to avoid going over this limit to make sure they don't have problems with the regulator," says Delessert. "They are good solutions but they are afraid to take risk to go other their limits. That is the big problem."

As Gort says: "The 15 per cent limit is really just a guideline but it takes some guts to cross it, and I'm not sure how many people are willing to."

If rates stay where they are, however, time will tell. ■

A challenging future

THE PENSION FUND for the canton of Zurich, BVK, is the largest in Switzerland by members, with 114,000 across 470 affiliated employers, and the second largest by assets, with CHF 28.5 billion in last year.

Like others its funding ratio increased in the last year, reaching 99.3 per cent, but it gained less than some due to a 'comprehensively hedged' currency position. As a result, its assets returned 6.1 per cent last year, rather than the 8.4 per cent it would have achieved without the hedge. In January, however, it was thankful this was in place.

"We have 85 per cent of our assets hedged, so our foreign investment didn't have a big impact," says BVK chief executive Thomas Schönbächler. It suffered from the turmoil on the Swiss exchange – with a CHF 900 million loss, but without the hedge it would have been another CHF 1.3 billion.

Not surprisingly, perhaps, Schönbächler says the hedge will stay in place, particularly since it has more foreign bonds than Swiss bonds in its portfolio (18 per cent against 17 per cent). It mainly takes currency risk in its emerging markets allocations.

"We don't take tactical bets on foreign exchange," he says. "We believe it's worth the cost and better to invest this risk budget elsewhere."

As for the other big challenge facing Swiss pensions, though, there is less certainty how to proceed.

"It's a huge challenge how to cope with the extremely low interest rates," he says. The fund needs annual returns of about 3 per cent to maintain its coverage rate, he adds. At the moment, there's no certainty where it will come from.

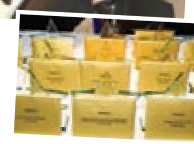
BOOK YOUR TABLE

European Pensions AWARDS 2015

European Pensions Awards 2015 Call for entries

The European Pensions Awards have been designed to recognise outstanding achievement in the varied fields of European pension provision, honouring the investment firms, consultancies and pension providers across Europe that have set the professional standards in order to best serve European pension funds in these increasingly challenging times. Our seven previous awards were hugely successful, each receiving hundreds of nominations from key providers across Europe.

The deserving winners will be announced at a prestigious Gala Dinner and Awards Ceremony on the 25th June at the Grosvenor House Hotel, Park Lane, London. The event will play host to hundreds of pension professionals from across the European pensions sphere.



The European Pensions Awards 2015 Categories

General categories

1) European Pensions Consultancy of the Year
2) Investment Manager of the Year
3) Equities Manager of the Year
4) Fixed Income Manager of the Year
5) Alternatives Investment Manager of the Year
6) Hedge Fund Provider of the Year
7) Property Manager of the Year
8) Infrastructure Manager of the Year
9) Private Equity Manager of the Year
10) ETF Provider of the Year
11) Emerging Markets Manager of the Year
12) Risk Management Firm of the Year
13) Currency Manager of the Year
14) LDI Manager of the Year
15) Passive Manager of the Year
16) Index Provider of the Year
17) SRI Provider of the Year
18) Fiduciary Management
19) European Pensions Law Firm of the Year
20) Custodian of the Year
21) Transition Management Firm of the Year
22) Pension Provider/Life Company of the Year
23) Buyout Firm of the Year
24) Pension Scheme Administrator of the Year
25) Pensions Technology Provider of the Year

Special categories

26) European Pensions Innovation Award
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European Pensions
AWARDS 2015

European Pensions Awards Gala Dinner & Ceremony

The European Pensions Awards 2015 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 Jo Caulfield and after show party with dancing until late, the European Pensions Awards 2015 will be a night to remember.

Host for the evening:

Jo Caulfield is a stand-up comedian, host, and comedy writer. She has worked on some of the biggest shows, and with some of the biggest names, in British comedy. Not only has Jo been the regular warm-up performer for Have I Got News For You for many years, she has appeared as a guest on the show, as well as on Mock The Week and Never Mind The Buzzcocks.
'Brilliant...endearing...feisty and garrulous' - **The Guardian**

Timings for the evening:

7pm	Drinks reception in the Ballroom Foyer
8pm	Dinner followed by the Awards presentation in the Ballroom
11pm	Disco and Fun Casino
2am	Carriages

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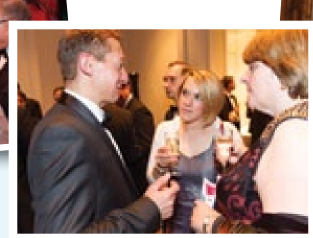

ESG focus: BREATHING NEW LIFE INTO INVESTMENT

Reaching new heights with low carbon investment

We explore how the growth of low carbon investment and how reducing exposure to high carbon producers is not as difficult as it may seem, even in emerging markets

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The ESG radar

Andrew Williams **analyses the impact of environmental, social and governance factors on European pension funds' decision making and whether interest in this area is becoming stronger**

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INVESTMENT

Reaching new heights with low carbon investment

Low carbon investment is growing in popularity, and reducing exposure to high carbon producers is not as difficult as it may seem. Emerging markets can now be accessed in a low cost and transparent way, whilst keeping carbon exposure in check

WRITTEN BY MAMADOU-ABOU SARR, GLOBAL HEAD OF ESG AT NORTHERN TRUST ASSET MANAGEMENT

There are growing concerns about the financial risks posed to investment portfolios by climate change. In order to meet the United Nation's stated goal of keeping global warming to a maximum of 2°C above pre-industrial levels, some climate models predict that 80 per cent of listed companies' proven reserves will become stranded[1] [i.e. the assets will not be utilised]. This could imply that the fossil fuel listed enterprises could suffer from a disproportionate negative impact on costs as their share prices are mostly derived from proven reserves[2]. By this accounting, \$20 trillion in assets would potentially need to be written off from balance sheets. Does this mean we are about to witness a surge in low carbon strategies?

Climate change is heating up

The focus on climate change has been heating up around the world in the past couple of years. The recent UN climate change summit was attended by an unprecedented number of heads of state and government officials and over 800 leaders from business, finance and society. The summit sought to crystallise a global vision for low carbon economic growth and to advance climate action. The two largest takeaways were:

1. Leaders commit to limit global temperature rise to less than 2°C from pre-industrial levels.
2. Commitment to finalise a meaningful, universal new agreement under the UN Framework Convention on Climate Change (UNFCCC) in Paris in 2015.

Shortly following the UN Climate Change summit was the 'PRI in person' conference in Montreal. This conference sought signatories to the Montreal Carbon Pledge, an initiative where investors will measure and publically disclose the carbon footprint of their investment portfolios on an annual basis. The aim is to attract \$500 billion of portfolio commitment in time for the UN Climate Change Conference in December 2015.

Translating ideas into investment criteria

We have seen discussions developing within the investment space for some time regarding reduction of fossil fuel exposure and stranded carbon assets. The focus of this has been around the consensus of scientific research is that the atmospheric CO2 level needs to be kept under 450 parts per million. The world currently has carbon reserves up to five times higher than this limit would allow, which has led for calls of mass divestment from carbon polluting organisations. The near meteoric rise of 350.org has been well documented, with CNN calling it the "most widespread political activity in the planet's history".

However, whilst full divestment is unlikely, it has raised questions within the investment community around less drastic options to reduce fossil fuel exposure. The investor interest has led to a flurry of funds and indices being created. With fossil fuel usage being particularly poignant in emerging markets with China being by far the largest producer of CO2 omissions and India the fourth largest producer of CO2 omissions. Another key area of focus we are seeing from investors is limiting the carbon exposure within their portfolios. Following the Kyoto Protocol (2005) and the United Nations Copenhagen Accord (2009), countries are signing legally binding agreements to limit/reduce emissions of greenhouse gases. The commitments are substantial with industrialised countries needing to reduce emissions by 25-40 per cent below 1990 levels by 2020 and 80-95 per cent by 2050. This will impact profits, locations and investment decisions for carbon resource intensive companies.

Carbon screening and emerging market investing

The focus on carbon exposure is an important element when discussing emerging market investments, since 70 per cent of projected global emissions will be generated in developing countries by 2050 and a large share of assets in emerging markets are allocated to resource/carbon intensive companies where low carbon policies may disproportionally affect costs. Therefore investors need to consider risks and opportunities within emerging markets.

As a result we created the Northern Trust Emerging Markets Low Carbon fund in partnership with MSCI ESG Research and a large Nordic pension fund. The low carbon fund is designed to reduce exposure to high carbon producing companies in the emerging markets whilst maintaining characteristics similar to the MSCI Emerging Market Index. The fund tracks the performance of a custom index [MSCI Emerging Markets Custom Low-Carbon Optimised Index] which excludes companies on the following criteria:

- Issuers with largest carbon reserves until 50 per cent of the total carbon reserves of the MSCI Emerging Market Index have been excluded.
- Issuers with largest emissions until 25 per cent of the total emissions of the MSCI Emerging Market Index have been excluded.

The custom index is also optimised and has restrictions applied to tracking error, turnover, sector and country weights. As of November 2014, the overall reduction of exposure to carbon emissions for the MSCI Emerging Markets Custom Low-Carbon index was 90 per cent and the overall reduction of exposure to Carbon Reserves was 98 per cent[3].

Regarding our low carbon solution, we are also able to successfully combine a compensated risk factor (quality) with a carbon dataset (CarbonMetrics) to deliver a solution that meets multiple objectives, namely a reduced carbon footprint and a strong information ratio. The table below summarises different approaches to carbon reduction:

Whilst new indices have been developed over the past few years to address climate change concerns, a challenge remains when trying to price carbon in the market. The momentum is building for putting a price on carbon emissions. Today few countries, cities and states are using carbon pricing mechanism in anticipation of standardisation and enforcement of carbon pricing. For companies that have high volumes of carbon emissions, they are not charged for the negative externality that the public faces. The problem relies on the fact that it is hard to specifically price negative externalities due to the uncertainty surrounding climate change and its potential effects that may happen in the future. Putting a price on carbon may incentivise producers to be cognisant of greenhouse gas emission, and could potentially be more effective than the command-and-control approach of policies today. All the stakeholders will play a key role in defining a global standard pricing mechanism for carbon pricing. A development to watch in 2015.

For more information on how Northern Trust can help you achieve your low carbon investment goals, please contact:

NT-AssetManagement@ntrs.com

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	Approach 1: Exclude and reweight	Approach 2: Exclude and optimise	Approach 3: Optimise with no exclusions
Description	Exclude securities that meet carbon criteria (for example, potential carbon emissions > 0) then cap-weight the remaining securities	Exclude securities that meet carbon criteria, then optimise to desired specifications (tracking error, turnover, sector/country misweights)	Optimise to reduce the carbon footprint while controlling for other risks or seeking other objectives (e.g. quality)
Examples	FTSE Fossil Fuel Free	MSCI Low Carbon Leaders MSCI Emerging Markets Custom Low-Carbon Optimised	MSCI Low Carbon Target Northern Trust Quality Low Carbon

[1] M. Meinhausen, N. Meinhausen, et al, "Greenhouse-Gas Emission Targets for Limiting Global Warming to 2C," Nature, June 2009
[2] Bill McKibben, "Global Warming's Terrifying New Math," Rolling Stone, July 19, 2012 *[3] Source MSCI ESG research*

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INVESTMENT

The ESG radar

Andrew Williams analyses the impact of environmental, social and governance factors on European pension funds' decision-making and whether interest in this area is becoming stronger

WRITTEN BY ANDREW WILLIAMS, A FREELANCE JOURNALIST

The influence of environmental, social and governance (ESG) issues on the long-term value of funds is increasingly recognised. So, how much focus do European pension funds put on ESG? Which European funds are leading the way and has the focus on different ESG issues changed at all in recent years?

Out to sea?

According to London Business School executive fellow David Pitt-Watson there is continuing growth in ESG, with interest ranging from the way people invest to the way they engage with companies, even extending to the way they participate in public policy debates.

"This didn't happen 20 years ago. Of course cynics may say that the ESG focus is swimming against the tide. But if that hadn't happened we might be miles out to sea by now," he says.

Northern Trust Asset Management global head of ESG Mamadou-Abou Sarr also believes that ESG uptake is "particularly strong" in Europe, and he cites the *2012 Global Sustainable Investment Review* - the first report to collate the results from the market studies of regional sustainable investment forums from around the world - which reports that volumes of ESG-related assets more than doubled over the five years to 2012 and that sustainable investments now account for 49 per cent of total assets under management in Europe.

"The size of the European market is driven by a higher proportion of assets taking into account ESG considerations in the overall asset management industry relative to the other regions," Sarr says.

Eurosif (European Sustainable Investment Forum) executive director François Passant agrees that interest in ESG is rising, but paints a more nuanced overall picture. In his view, the "glass half-full optimist" would say that the focus on ESG has "clearly increased" within the pension fund segment in recent years and he points to Eurosif's latest *European SRI Market study*, which reveals that the growth of European ESG assets once again surpassed growth in the broader asset management market in Europe between 2011 and 2013, and demonstrates that most of the European ESG market is driven by institutional demand.

"The glass half-empty pessimist would however point at the concentration of demand within the top end of the pension market. If it is true that larger European pension funds have for a large part embraced ESG, it is less clear that the rest of the pension market is engaging in this path," he adds.

Passant says that Eurosif's 2011 corporate pension fund survey also found that pension funds are often confronted with a number of contradictions in this area. Amongst other things, it revealed that only 56 per cent of funds have a responsible investment policy, but that 60 per cent felt that ESG factors can affect their long-term financial performance and 66 per cent saw ESG as part of their fiduciary duty.

"ESG is often perceived at the smaller end of the pension market segment as costly, lacking clarity and not compatible with fiduciary duty. Industry leaders and RI organisations like the UNPRI or the SIFs have to contribute to work with pension trustees to demonstrate

that ESG is indeed a valid route for smaller pension funds and does not need to be costly," Passant adds.

'Commitment with clout'

In terms of the spread of ESG activity across the European market, Sarr says that the main initiatives are led by the UK, the Nordics and the Netherlands - and points to 'key indicatives' such as the cluster munitions ban in the Netherlands, the UK responsible investment guide and stewardship code and the carbon disclosure project (CDP) led by the Swedish Pension Fund AP4.

While he believes that good practice can be found in all countries, Pitt-Watson also singles out AP4 for its 'pioneering' approach to decarbonisation at scale, as well as the 'giant' Dutch funds for their solid performance and commitment with clout, and the UK Environment Agency Pension Fund.

"All of these approaches are justified on financial grounds, as well as on ESG grounds. The key is to align financial, social and environmental sustainability," he says.

Although he points out that ranking SRI and ESG practices is a 'difficult exercise that might lead to false conclusions,' Passant reveals that the *Eurosif 2014 European SRI Market* study found that there are some broad regional differences in the way pension funds tackle ESG. For instance, Nordic pension funds tend to practice the so-called 'norms-based screening approach', whereby a 'universe of investments' is screened against a set of internationally recognised norms such as those developed by the UNGC, OECD and ILO.

"This screening can lead to shareholder engagement with the investee company or divestment. In other markets, the stewardship dimension may be emphasised, such as in the UK and the Netherlands, meaning that engagement and voting are particularly popular," he adds.

Themes

In Passant's view, the number of themes related to responsible investment is "theoretically endless", meaning "it is challenging to find commonalities across European pension funds". Nevertheless, he says that three core themes have emerged and are now widely discussed within the industry.

The first theme is climate change, especially in the context of the debate around fossil fuels divestment and stranded assets, and Passant reveals that various initiatives have been launched to encourage asset owners to incorporate climate change considerations into their investment policies, such as the September 2014 Montreal Pledge, which encourages investors to commit to measure and publicly disclose the carbon footprint of their investment portfolios on an annual basis.

For Passant, the second key discussion point in the industry is human rights, especially as it relates to supply chains.

"The Rana Plaza situation is still in the mind of everybody and the recent POSCO case has illustrated the perils of failing to proactively oversee how investee companies manage human rights misconducts. Pension funds are paying more and more attention to this, not only for ethical reasons but also to protect their reputation, or their 'licence to invest,'" he says.

The third theme that Passant says is gaining traction is impact investing. A recent Eurosif overview of the European institutional impact investing market reveals that this is the currently the fastest-growing ESG strategy, albeit from a low base. While impact investing can take different forms across markets, it generally demonstrates a desire to generate a directly measurable social and environmental impact. Impact investments typically cover investments into social enterprises but some pension funds also include private equity or infrastructure investments in this category.

"Larger pension funds in the Netherlands seem to be pioneering this area but are by no means an exception," Passant comments.

Meanwhile, Sarr points out that the focus of pension funds is not only evolving to align with the key ESG themes, but also to evolve in time with other pension funds, as they develop responsible investing policies. Looking ahead, he predicts that the biggest drivers of ESG growth and investment focus will be the evolution of the regulatory framework, as well as a continued focus on ESG performance and a growing recognition of the need for the greater integration of ESG factors across asset classes.

"ESG is a fast-moving field, impacted by both macro issues, [such as] climate change, water and energy, and micro issues, including human rights, diversity, supply chain and labour rights," he adds.

Ultimately, Pitt-Watson thinks that the types of ESG issues that funds focus on "can come and go a bit" depending on whether they are in the public eye, something that he believes is natural and to some extent healthy.

"It is perhaps easiest to incorporate governance within the traditional investment management disciplines. But I think the biggest issue which everyone has to focus on is the environment. The cost to our savings, and to our lives if we fail to solve that one is terrifying," he says. ■

INVESTMENT

Gaining leverage

Lynn Strongin Dodds **explains why leveraged loans are experiencing a surge in popularity with European institutional investors, and how the emergence of 'covenant lite' issuers will affect this interest**

WRITTEN BY LYNN STRONGIN DODDS, A FREELANCE JOURNALIST

Leveraged loans may be winning a place in the European institutional community but it could be several years before they have a foothold in the retail space. Unlike in the US, regulatory constraints prevent funds from having a meaningful allocation and it is unlikely to change in the near term.

"The dynamics are different and we do not have dedicated retail leveraged loan funds in Europe," says Aon Hewitt global head of fixed income research Lennox Hartman. "In some cases this is not a bad thing in that it allows institutional investors to explore the European market without the fear that there will be a massive run to the door."

Under Ucits regulation, retail funds can only invest up to 10 per cent in leveraged loans provided that they qualify as money-market instruments. By contrast, US mutual and exchanged-traded funds that bet primarily on leveraged loans account for a third of the market. They amassed around $113 billion of assets last year, up from the roughly $20 billion before the financial crisis of 2008, according to data from Lipper.

Retail decline

However, last year's tally, albeit impressive, was expected to be even higher. Few predicted the $17 billion of outflows as retail investors switched their affections to the better performing high yield bond market. Leveraged loans, which are floating rate notes and provide a hedge against interest rate rises, lost their attraction when the Federal Reserve did not reverse their policy as expected. Analysts expect the exodus to continue until there is an actual rate increase and Treasury yields finally start to climb.

Not surprisingly the retreat has had an impact, sending prices lower in the secondary market. The flipside is that many market participants believe it has created a more balanced and less technical market than when retail money was pouring in. The deals were offering better yields and structures to attract investors. Collaterised loan obligation (CLO) funds, which comprise roughly two thirds of the demand, also helped put a floor underneath as several funds bought loans at lower prices for their new vehicles that they are establishing to comply with the Volker rule by 2017.

The lack of appetite combined with increased regulatory scrutiny of leveraged loan underwriting standards and impending risk retention rules are expected to dampen issuance. S&P Capital IQ Leveraged Commentary & Data (LCD) forecasts a 24 per cent to 34 per cent decline in the US market from 2014's $529 billion of volume, which was 12.7 per cent down from 2013's all-time high of $607 billion.

European growth

By contrast, albeit a fraction of the size, the European loan market, which issued €78 billion of new loans last year, has had a better start to the year. Research from ECM Asset Management showed there was €8.15 billion of issuance in the first month with a strong pipeline for the rest of 2015. Returns have also been healthy with the Standard & Poors European Leveraged Loan Index delivering 1.14 per cent for January or 0.67 per cent taking out the currency effects.

The main driver is the return of M&A activity by the private equity community, which drives 75 per cent of the European sub-investment grade loan new issuance market, according to ECM. Deals that are expected to be financed with high-yield debt include Altice's €7.4 billion purchase of Oi's Portuguese telecom assets and Canadian Onex Corp.'s €3.75 billion buyout of SIG Combibloc Group.

Although there is no breakdown of figures, buyers in the European markets have mainly been specialist loan funds that have invested via collateralised debt obligations or CLO funds. Pension schemes have treaded more cautiously and are likely to allocate between 1 per cent to 5 per cent in either their total fixed income portfolio or as part of a liability driven investment strategy.

CQS head of loans at multi strategy asset management firm Craig Scordellis says: "At one time banks and CLOs accounted for perhaps as much as 90 per cent of the senior secured loan market but they have fallen away and are being replaced by pension funds and other types of funds. As we see them understand the products more, they are beginning to understand their relative value. For example, today, the spreads are higher than what is generally earned on high yield bonds, which means that they are taking less risk and getting paid more."

"The conversations started around three to four years ago with the larger schemes but they only started to move into action over the past year or two," says Lyxor head of debt fund management Thierry de Vergnes.

"It was a long evolution because, while loan funds were common in the US, European trustees were initially suspicious about bank debt packaged into debt funds. However, they have spent time understanding how they work and realise that it is senior secured debt that pays around 400 plus basis points over government and investment grade debt."

Henderson head of loans David Milward adds: "The low yielding environment is also a big driver for demand. There are some clients who are looking to de-risk and are allocating to loans by selling down equities but the real interest is in assets with attractive relative returns and low volatility. If you look at deals available in investment grade and government bonds across Europe, they reached such low levels and pension funds are looking for higher yielding instruments. Loans is one area where the risk reward is attractive."

Covenant 'lite' issuers

Although demand is expected to continue to rise, investors are growing concerned over the increase of a new generation of covenant 'lite' issuers coming to the market. Traditionally, these loans have had no maintenance covenants but the new so-called 2.0 version allows companies to increase the size of restricted payments baskets, and issue extra debt at whatever rates borrowers choose. They have been a particular feature of the US market and the fear is that these looser lending standards could bring bigger losses to investors in the next default cycle.

Although less prevalent, they are also becoming a feature in Europe, accounting for around 25 per cent of issuance. Research from Deutsche Bank, BNP Paribas and Bank of America Corp revealed that the movement is growing with junk-rated borrowers raising €17.7 billion of the loans in 2014, more than double the previous record, according to data from S&P Capital IQ LCD.

"The biggest negative at the moment is not the pricing but the structure of deals," says M&G Investments leveraged loans fund manager Dan Gardner. "The US has always been more accepting of covenant lite loans but Europe is following the trend and we are seeing an increase in the number of euro-denominated deals without maintenance covenants, but admittedly with less leverage.

"The most important thing in these cases is to do the due diligence because not all loans are created equally. Generally though we prefer loans with maintenance covenants, aligning our interests as lenders with those of the owners if the business does not perform well."

For Eaton Vance vice president, director of income product & portfolio strategy Chris Remington, 'covenant lite' does not mean 'covenant free'. "These loans still offer lots of creditor protections. This development isn't a sign of weakness but rather one of market maturation," he explains. "Today it's much faster to vote with your feet in the secondary market than to pursue lengthy negotiations over broken covenants."

Instead, covenants are but one criteria among many more important factors for analysis, Remington adds. "We have a detailed bottom-up credit process that analyses a range of factors such as size and scale, leverage, interest coverage, competitive position and barriers of entry, growth potential and the strength of management. The coupon, liquidity and volatility are inputs too. The list goes on."

Given the complexities of the asset class, the expertise of the asset manager is key, according to Barnett Waddingham partner David Clare. "You need experienced managers who can demonstrate their skill and ideally have worked on the investment banking side to understand how loan packages are put together and syndicated. In my opinion a measure of success is not how many deals they have participated in but how many they have refused. A good manager could only invest in 50 per cent of the deals put in front of them." ■

Alternatives focus:

TREADING NEW PATHS

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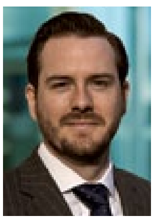
INVESTMENT

Building long-term interest

Geoffrey Shaw **explores the case for investing in long-lease property**

WRITTEN BY GEOFFREY SHAW, DIRECTOR, PORTFOLIO MANAGER, BLACKROCK UK LONG LEASE PROPERTY FUND



Since the advent of quantitative easing, government bond yields, even long-dated bonds, have traded at all-time lows, making it harder for institutional investors to find sufficient returns to meet their liabilities. Investors looking to hedge against inflation have also seen yields plummet, with index-linked gilts currently trading at negative yields. Against this backdrop, investors of all kinds are looking beyond traditional bond investments to other forms of secure income-generating assets, such as property, that typically offer higher yields than government bonds over the long term.

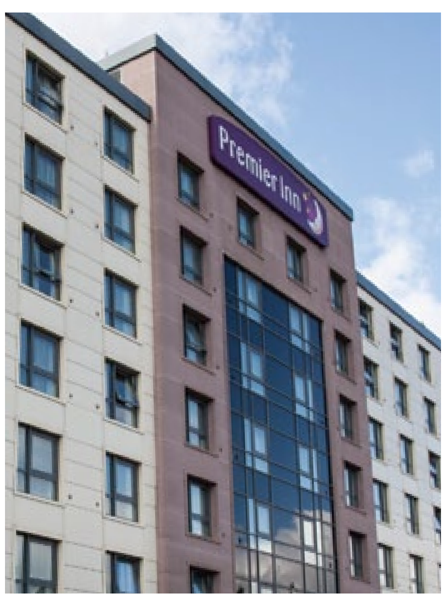
Long-lease property fits many of these requirements. It delivers predictable, long-dated income streams, secured against underlying assets, which are contractually obliged to increase in line with inflation or by fixed amounts. It also offers diversification benefits and higher yields than government bonds. These attributes make long-lease property suitable for many investors seeking to meet liabilities in the current low yield environment.

Investing in property

As an asset class, property benefits from a combination of bond- and equity-like characteristics as it offers stable revenue streams with the opportunity for capital appreciation. It also benefits from being a physical asset, not just a piece of paper or an electronic claim over something intangible.

Property investing, broadly speaking, falls into three categories (see table opposite). The highest risk and the most capital-intensive is property development, where returns are likely to be forecast based on gearing and IRR calculations. A classic property development strategy is to buy the worst building on the best street, substantially redevelop it and then sell it at a profit.

More traditional 'core' property investment targets returns through rental income and capital growth by actively managing and improving the properties invested in. Key objectives are ensuring that vacancies are low and the properties are maintained to achieve a good return on investment.



Long-lease property investment should be the lowest risk as it seeks high quality tenants who will remain in the property for the long term. Regular rent reviews are typically agreed when the lease is signed, which are either linked to inflation indices such as a consumer price index (CPI) or retail price index (RPI), or set to rise at a fixed rate. The cost of investing in this type of strategy is also lower than traditional property investing as the lessee remains responsible for upkeep and maintenance of the asset.

Essentially, the focus of long-lease property investment is on long-term stable income streams rather than capital appreciation. For example, a fund might purchase an office building with a 25-year lease and hold it for 15 years, harvesting the income and selling it before any major renovations are required.

Searching for higher yield assets

As the asset class has grown in popularity and prices have risen, investors have to work harder to achieve the yields that were available in the past. Strong in-house capability to research developing business trends, new sectors and tenants will provide an advantage. For example, the evolving retail environment is leading to new opportunities as the large supermarket chains shift their focus to opening smaller, more conveniently-located stores rather than the large out-of-town mega markets.

Understanding a tenant and the

	LONG LEASE	TRADITIONAL/CORE	DEVELOPMENT
Risk	Lower	Medium	Higher
Strategy	Income harvesting	Market return	Value creation
Rent review	Inflation linked	Market based	Market based
Return type	Income focused	Mix of income and capital	Capital focused
Expected return	c. 5%-7%	c. 7%-9%	c. >9%

Source: BlackRock, 2015.

outlook for their business in the current climate requires rigorous due diligence. Collaboration between analysts with real estate, fixed income and equity expertise can help this process. For example, there are a number of tenants in the marketplace who, despite having been through tough times, have restructured successfully. Tenants with strong, recovering fundamentals are often overlooked by the wider market and may present an attractive investment proposition.

Additionally, new and emerging business sectors can offer attractive opportunities. These will be more difficult to analyse due to the lack of available data. Examples of these include private hospitals in healthcare and car parks in infrastructure.

The importance of inflation-linked characteristics

With index-linked gilts currently trading at negative real yields, long-lease assets are appealing as they offer predictable and growing income to investors through exposure to real estate investments, where rental income growth is linked to inflation or subject to pre-agreed rent rises.

As a ‘real’ asset, the physical property not only acts as collateral to the income stream, it is also indirectly linked to inflation. Strong economic activity will improve rental value, which in turn should increase the value of the underlying property.

Diversification benefits

Long-lease assets exhibit a lower degree of volatility than the broader property market, providing a valuable stepping stone into the sector. The long-lease property market has delivered more stable total returns than the broader UK property market over time. Real estate benefits from a lower sensitivity to rising interest rates than the bond market, and has lower market risk than equities.

Along with providing diversification across asset classes, exposure to a long-lease property fund can provide diversification in its own right. By selecting a range of different locations, sectors and tenants, it is possible to benefit from the supply and demand dynamics of different industries and geographic regions. The factors impacting a car park in Canterbury, for example, will differ from those affecting an office building in Glasgow or a hospital in Bristol.

Potential risks

The three principle risks in investing in long lease property are:

Liquidity risk: Real estate is not a very liquid asset class and investors should only consider it as a long-term investment. Should assets need to be sold, this may take time and will depend on prevailing market conditions. Risk can be mitigated through careful portfolio construction and by including more liquid assets in the portfolio.

Credit risk: A tenant entering administration will have an impact on value and distribution. This can be mitigated by in-depth credit analysis both on acquisition and on an ongoing basis. Portfolio diversification will help to reduce risk.

Market risk: The value of any long-lease portfolio is based on market sentiment, and values can go up as well as down. As with credit risk, portfolio diversification will help mitigate the risk.

The right investment partner

Long-lease investments trade on private markets, making it harder to source investment opportunities. Deep market knowledge and extensive research is required to find the best deals with the best terms as they arise. Of particular importance is the ability to assess the creditworthiness of all parties involved in a deal.

Outlook

The outlook for long-lease property remains strong. With the UK economy on the recovery path, interest rates are expected to rise this year. However, we do not anticipate a sharp rise in rates, or a rise to levels that will erode the attractiveness of the stable and growing income stream the sector offers long-term investors. Opportunities for above market average rental yields are available to those with the ability to research and invest in alternative real estate asset classes beyond the traditional offices and retail outlets. ■

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INVESTMENT

An alternative approach

Natalie Tuck explores why pension fund investors are increasingly moving allocations away from traditional investments and into alternatives

WRITTEN BY NATALIE TUCK

The idea of pension funds diversifying their portfolios by investing in alternatives is not a new one. Traditionally pension funds looked to fixed income instruments to generate income but with yields so low they have been turning to alternatives; something that BlackRock Alternative Investors managing director Ingo Heinen says he's seen over the past 24 months.

This is backed up by Carmignac member of the investment committee Jean Médecin, who says "alternatives are seen by pension funds as a way to deliver and obtain the yields they can't have anymore in the traditional fixed income space".

A mainstream alternative?

The *Towers Watson Global Pensions Asset Study* published in January revealed how the trend of investing in alternatives has increased over the last 10 years. From 1995 to 2014 alternative investments, especially real estate, hedge funds, private equity and commodities in the larger markets have grown from 5 per cent to 25 per cent.

It is this increase that has people such as Heinen saying we should stop calling them alternative investments because they have become such a core element of pension scheme investment.

"What is infrastructure debt for example, is it an alternative investment or a fixed income investment that's secured and gives you additional yield, certainly in respect to the risks you're taking on compared to equivalent, unsecured bonds," he muses.

Looking forward, the recent decision by the European Central Bank to introduce quantitative easing has reinforced the decision to invest in alternatives, adds Heinen.

Russell Investments' director of client strategy, Nick Spencer, says that pension funds look to alternatives because "we are still dealing with the twin challenge of equities being at, or close to market highs with bonds and yields being close to historic lows".

Real assets

It is widely acknowledged within the alternatives sphere that real assets are leading in the popularity charts.

Robeco portfolio strategist Roderick Molenaar says the trend is clear, adding that diversification, inflation protection and the illiquidity premia are reasons to invest.

Médecin states that real assets are a "good source of value in times of monetary experiments".

Spencer notes a strong theme across pension funds is to look for real assets outside of their domestic market, especially the larger pension funds. These include assets such as real estate, infrastructure and natural resources such as farmland and timber.

Spencer says there is a lot of interest surrounding real asset debt strategies adding that they're looking to complement bond returns by investing in slightly less liquid sectors. He explains that the illiquidity premium on real assets can give an enhanced rate of return, in a very bond-like fashion.

However, as Molenaar states the

advantages of investing in alternatives are not "always easy to prove" and should be backed by the "investment beliefs of the institutional investors".

He adds pension funds are looking more favourably on ESG issues, which can be a reason to switch to impact investing, but certain parts of real assets do not fit within the guidelines of ESG policies.

Médecin also states the downside to investing in real assets, using real estate as an example, is that due to increased popularity the price of investing in property has increased. However, as they are usually longter investments the value will usually increase over time, making it a popular asset for pension funds.

European diversity

Across Europe pension funds differ when investing in alternatives, which comes down to the different regulations that some of the pension funds are subject to, explains Heinen. He adds that even within countries, depending on the form of the pension fund, there are different regulations.

Médecin says that pension funds have a lot more pressure from the regulator and highlights how in the Netherlands, the regulator is putting pressure on the ratio of liabilities versus assets.

"The regulatory pressure is forcing them to find asset classes or investments, which can compensate the low yield in fixed income but at the same time won't create too much volatility in the performance and that's where alternatives come into force," Médecin explains.

Molenaar says several, mainly the larger, Dutch pension funds are looking towards infrastructure and real estate or mortgage propositions. However, he says there is a public debate on pension funds in this field and the role of funding SMEs.

Furthermore, some of the problems banks are facing in their risk framework (Basel III) are also present in the risk framework the regulators are implementing for institutional investors," he explains.

However, Unigestion head of portfolio management, private assets Christophe de Dardel notes the different investment trends across the European private equity markets.

"While certain north European private equity markets tend to become overcrowded and overpriced, southern European markets are re-emerging fast. Spain, for example, which was a sort of Eldorado 10 years ago and was then deserted by investors for some years, is coming back on the agenda for investors."

The real challenge

The biggest challenge for pension funds when investing in alternatives is to pick a good asset manager. Heinen says "manager selection is key" as you want to work with people who provide you with knowledge transfer, competitive fees and who provide you with unique insights.

"In pension fund land sometimes opportunities arise and you know very often because you don't have dedicated teams you can't act quickly, and you can't react to markets and opportunities arising or disappearing quickly enough.

"That's why you should consider working very closely with a couple of asset managers that you mandate with choosing the right investments for you within a broader alternatives mandate," he explains.

Spencer too believes that focusing on the "skills of managers rather than the market returns" is something that should be higher up on pension funds' lists.

Dardel adds that investors should seek to combine private assets in such a way that they achieve what they are expected to achieve.

"Traditional allocation methods based on risk and return data does not work well in private assets: solid return data is not always available, they are subject to stale pricing, and they include hard to measure illiquidity premiums. For assembling a purposeful portfolio of private assets, a holistic, objective driven approach is required," he explains.

Pension funds and their asset managers should also consider things such as the fund structures, explains Spencer.

"Even if it's open you might only be able to trade quarterly and even then you may have to wait to get your money in and get your money out, when buying directly you have to psychically go round and buy and sell so there's a lot more time involved," he says.

Spencer also believes many people will have concerns with regards to illiquidity as they are very familiar with dealing with public markets. In the UK 70 per cent of the cashflows of their pension funds is going to be paid out 10 or more years into the future, Spencer states.

He explains people want illiquidity as a comfort but they don't want to imeplement it and notes that even though pension funds can't put all their assets into illiquid investments there is a lot of scope.

"In particular today where we've had money and QE herding into the public markets, we feel that this illiquidity premium is one of the stronger premiums still available and that is something that institutional investors can really access in a way that is quite challenging for individual investors," he concludes. ■

INVESTMENT

Making the grade

Sandra Haurant looks at the role investment grade credit can play in pension fund portfolios and the challenges surrounding this asset class

WRITTEN BY SANDRA HAURANT, FREELANCE JOURNALIST

Investment grade credit, or IG, has long had an important role to play in pension fund investment. IG generally refers to bonds with a BBB rating or above, and the asset class has traditionally had plenty to offer for pensions, particularly where liability matching is concerned.

"Pension funds ultimately have cash flows that are fairly predictable - you can say with reasonable certainty how much outflow you are going to have each year," Barnett Waddingham partner Rod Goodyer explains.

"So ideally you would like assets that were similarly predictable, in that they would provide you with the same income pattern. And what you would also like is the value of those assets in the interim to move consistently with the value of your liabilities being placed by the actuary," he says. "Because then, when you do your funding assessments you are not seeing volatile contribution demands – it will be reasonably stable on the company's balance sheet. So potentially bond assets are excellent for doing that because they are very stable."

Challenges

While they may not be a volatile choice, the IG area does present something of a challenge for pension schemes. IG has traditionally enjoyed an extra yield margin compared with gilts, but as PiRho Investment Consulting director Phil Irvine says: "IG yields versus gilt yields are relatively compressed now, so perhaps on a tactical basis they are not as favoured as before".

Indeed, Conning senior credit analyst Anke Richter adds: "When you look at where credit high grade products stands these days, the outlook for returns is very challenging."

Yields are at historic lows and there is no sign of any great change on the near horizon. The key thing, Richter says is that, with the current climate and quantitative easing (QE) in the Eurozone "it doesn't look like it's a temporary phenomenon".

He explains: "From a pension point of view, if you look at allocations you think that it is an unusually weak year, that's one thing, but if you have an outlook that is not very good for maybe a couple of years, then obviously it brings more to the fore the question of how you want to be allocated to different asset classes."

Indeed, Richter says, while gilts continue to offer low yields - German government bonds (the Bund) are at lows that were unimaginable not so long ago, and credit spreads are making up a significant chunk of returns – the corporate bond space offers little in the way of respite.

"When you look at the recent seven-year EUR Unilever bond issue, Unilever is a good solid company, but will only pay a coupon of 0.5 per cent. So I think that illustrates that returns in high grade credit are quite compressed and challenged. With QE just about to start in Europe, there is little prospect of this changing any time soon," he adds.

And the consensus appears to be that it is staying that way.

"We have seen yields dropping and we might see yields low for longer," AXA IM senior credit fund manager Lionel Pernias comments, who nonetheless argues that there is value to be found in this area.

"We expect yields to stay low on the back of European Central Bank actions; we don't see the policy changing before September in the US, and probably before next year in the UK, and we don't see yields going a lot higher. I think we have to get used to this low yield environment at least for the next few months and for 2015," he adds.

Liquidity may also become a challenge in the future, Irvine argues. "Liquidity in some of the corporate bonds will be an issue at some stage. The lesson from 2008 is that the terms offered on the funds need to be in alignment with the liquidity of the underlying asset class. It seems likely to me that in a market panic, with banks no longer able to hold much proprietary capital, then some of these funds will be gated or become distressed. Not ideal for a matching asset that is needed to pay pensions."

New approaches

Nonetheless, finding new approaches has become important. “We are seeing a lot of our clients who, in the past, have had passive investment grade bonds, moving to active. People want to have greater scrutiny of what they are holding,” Goodyer states. “We are seeing more interest in active approaches.”

Keeping in mind the important role IG plays in a liability driven investment (LDI), it’s clear that when pension schemes look for alternatives, they need to fill the same gap left behind by a classic IG approach.

“One obvious option is absolute return bonds, rather than a conventional investment grade mandate, because you could argue that this sits more neatly alongside an LDI strategy, where you can have a manager using swaps or gilts with leverage and so on to do the interest rate exposure element,” Goodyer says.

Instead of aiming for a certain return specifically from IG, a manager can be given a freer choice.

“You can effectively say to the active bond manager ‘use all your best ideas, be that in the credit space, interest rates, or other debt markets, but just try and get us the return from your best ideas,’” he says.

IG CONTINUES TO PROVIDE A CORNERSTONE FOR PENSION INVESTING, AND IS UNLIKELY TO BE REPLACED ANY TIME SOON

And pension schemes are also increasingly interested in broadening geographical horizons, Goodyer adds. “People in the UK are looking at the freedom to invest more globally, rather than just investing in the UK, to get some diversification benefit.”

AXA IM global head of consultant relations Lisa O’Connor agrees. “The move to global is probably key. People are looking for a greater opportunity set to be able to seek yield. It does depend, regionally within Europe, as to what they are doing.”

But in terms of the understanding of trustees in this area, there is some way to go to ensure that investment approaches can be as inventive as they need to be in a challenging environment, O’Connor says.

“The potential pitfalls in IG – from the importance of lower transaction costs to the asymmetry of returns have been accepted and understood, and I think the next stage of education is on the blending within a liability management programme, to be able to bring in everything you can to help manage cashflows. How you can increase the yield, but ensuring there is an awareness that when you increase the yield you are increasing the risk, and understanding your complete portfolio,” she explains.

Cornerstone

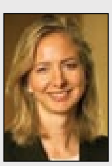
Enthusiasm for more innovative approaches has been growing, with infrastructure, private debt and bilateral agreements, as well as global credit, increasingly making up part of pension portfolios. But IG continues to provide a cornerstone for pension investing, and is unlikely to be replaced any time soon. Its role is simply too important for pensions – and nothing else can do quite the same job.

“The move to looking for alternatives to boost yield at the edges or the margins is something that a lot of them are looking at,” O’Connor explains.

“As they are building out their liability risk management programme, they are looking to sweat the assets harder by blending both an LDI approach and investment grade credit. That will help get the return above government bonds, but it also provides some diversification. And on top of that, they are looking at bringing in other assets – perhaps long lease or commercial real estate debt.” But ultimately, she says: “Our clients are still looking at an investment grade core to their matching portfolios.” ■

Currency roundtable: MARKET UPDATE

Chair:



LUCINDA DOWNING

Asset Allocation Specialist, Aon Hewitt

Lucinda develops asset class views within Aon Hewitt's global asset allocation team for investment advisory and delegated consulting clients. She was previously director of Balanced Funds at Russell Investments where she structured and managed multi-asset, multi-manager funds. Before then, she was a portfolio manager at State Street Global Advisors, where she managed bond and currency portfolios and created forecasting models.

Panel:

CHARLES GOODMAN

Head, Edmond de Rothschild Asset Management UK

Charles has been the CEO of Edmond de Rothschild Asset Management (UK) since 2012. He has been with the group for over 20 years, advising pension funds and other institutional investors on risk management issues, most recently as head of institutional sales in the Geneva office. Prior to that, he was an account executive in Geneva and Chicago for the FFM Group, a Swiss fund manager and derivatives specialist.

KLAUS PAESLER

CFA, Head, Currency and Overlay Strategy – EMEA, Russell Investment Group

Klaus' primary responsibilities are to design, implement, and manage portfolios for Russell's overlay services group. These strategies include currency overlays, cash securitisation, synthetic rebalancing, and options based strategies. Klaus also engages in speaking assignments on exposure management and foreign exchange strategies. Prior to joining Russell, Klaus was a senior equity portfolio manager with Mellon Capital Management.

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MICHAEL WILLIAMS

Vice Chairman and President, Cürex Group

Mike is vice chairman and president of the Cürex Group, based in New York. He has over 35 years of experience in the FX industry, including founding the first currency option brokerage platform, serving on the US Federal Reserve FX Committee, and holding senior management positions at Cantor Fitzgerald, HSBC and Knight Capital. He joined Cürex in 2009 when the company was founded as an original investor.

JAMES WOOD-COLLINS

Chief Executive Officer, Record plc

James joined Record in 2008, and was appointed CEO in 2010. He joined Record from J.P. Morgan Cazenove, where he had been a managing director advising financial institutions on M&A, IPOs and related corporate finance transactions, including the December 2007 IPO of Record plc. James joined J.P. Morgan in 1994, and worked in both the London and New York-based corporate finance teams. James chairs Record's Executive Committee.

Chair: Let's begin by talking about what's happened in the currency markets. There has been a lot of movement driven by macro and monetary policy developments – is it all good news for currency managers?

» **Wood-Collins**: The current environment is probably more optimistic than it has been for some time – we'd focus on the end of a highly convergent monetary policy regime and the move to more divergent policy, with central banks driven by local objectives rather than by a common global imperative.

We would highlight carry as being one of the main beneficiaries of that and we've seen that both in terms of performance and in terms of inflows. Carry strategies often benefit from an anticipation of widening rate differentials, even before those differentials come through, as the spot market prices that in. Diversified carry strategies have been performing well and we see fewer challenges in the future than we've had in the recent past, but that's probably true of some of the other strategies as well.

» **Chair**: What currencies do you like at the moment?

» **Wood-Collins**: We prefer a systematic approach to a discretionary one so we don't claim to take individual views on currencies. Instead we look at behaviour and we look at signals – whether it's an interest rate differential signal, a price movement signal or a fair value signal – and sometimes those point in the same direction. The pronounced weakening of the yen we've seen particularly against the dollar through 2014 has paid off in a number of different strategies, whether it's carry, value, momentum or otherwise.

» **Chair**: The one common denominator of all the major currency moves is the dollar strengthening. Is that a limiting factor to being able to add value by currency management?

» **Goodman**: In the recent past the biggest movements have been mainly dollar related. Now the divergence trend is essentially the US economy looking reasonably healthy while for the rest of the world it's still a race to the bottom, with many countries looking to weaken their currencies.As a currency manager we are only focused on hedging, so for the dollar-related mandates we are potentially positioned further away from our benchmarks – very under-hedged or very hedged depending on the underlying position of the clients – than we would be in other currency pairs where there has not been as much movement. Our value proposition to clients is to improve outcomes when there are large movements. Periods of currency stability are generally good news for hedgers and it is better for them if we are relatively inactive, whereas in periods of strong volatility we can help them to improve the global currency result.

» **Chair**: Any other thoughts?

» **Paesler**: Given a lot of our clients are European pension funds, we do a lot of hedging and, although the dollar does have an effect and is one of the larger moves, there's still a huge set of assets that aren't necessarily dollar based, other currencies that are still having an effect; so hedging is still a critical aspect. But I think the recent rise in the dollar also highlights the volatility in the markets. The dollar has strengthened significantly but could easily dive down in the future as well, so having a position in currency, whether you are actively looking to hedge something out or just being aware of what's going to be the effect on your portfolio, is going to be critical, one way or another.

"There is much more emphasis on passive and/or dynamic hedging today"

» **Williams**: I would agree it's a dollar play at least in the short term. I also think that short-term volatility is here and will create opportunities for currency managers. That's not just with regulatory type of arbitrage, but also interest rate differentials. The market structure is also diversifying, and liquidity is also going to be an issue going forward.

» **Chair**: I think that maybe the strongest held conviction of currency overlay managers is that the dollar is going to rise – what happens if it doesn't and does that mean that currency overlay managers are taking an undiversified risk?

» **Goodman**: I would not say that is a currency overlay manager's view. Most currency overlay managers today are more focused on hedging, whether passive or dynamic, and on providing a service as opposed to focusing on overall macro views.

» **Wood-Collins**: I would agree. Within the currency management arena there's a whole range of services from what we term 'passive hedging' at one end, which is more of an implementation service (i.e. there's no investment view in the product, although there's a strong investment rationale for implementing it), all the way through to pure currency return-seeking strategies.

I think if you were in that position, and you were running discretionary return-seeking strategies and you took a very concentrated view, absolutely you'd run the risk of being proved wrong - the currency market's very good at proving people wrong. But even within the constraints of return-seeking strategies, there are plenty of other diversifying approaches to avoid that reliance on any one movement.

» **Chair**: We have seen a significant move away in the currency management industry from active currency management – what are your thoughts on this?

» **Goodman**: There has been a massive move away from that. Standalone, unconstrained, pure alpha currency mandates have been more or less eliminated from most people's toolbox, at least on the institutional side. There is much more emphasis on passive and/or dynamic hedging.

» **Wood-Collins**: We've seen the pendulum swing and I think it's swung sufficiently far towards hedging that we are actually now starting to see it returning towards return-seeking currency. In our business, a dozen or so years ago it was entirely hedging. If you go back seven years, then in terms of client exposures it was half hedging, half return-seeking. We've now swung back towards hedging which again is around 95 per cent of the client exposures we manage. But in terms of where we're seeing new client interest, where we're seeing consultant interest and new inflows, it's also the return-seeking side of the business that has been growing in the last 12 to 18 months, albeit from a very low base. I would tie it back again to more divergent central bank policy, more prospects for rate differentials, more opportunities for trending and increasing volatility. All of these things are giving return-seeking strategies more material to work with.

» **Goodman**: There was a period when it was widely claimed that it was possible to extract consistent alpha from currency markets because many participants were supposedly not profit-oriented. That has been entirely debunked by the reality of returns obtained from 'pure alpha' strategies. As a house, we have never espoused currency as an asset class or unconstrained currency as an attractive vehicle for an investor's risk-seeking budget. We have always focused on risk management solutions.

» **Wood-Collins**: Two of the lessons we've learnt over the last five or six years would be around diversification and gearing – certainly in terms of the sorts of products that we see investors and asset allocators and consultants focusing on now. We're seeing more robust products, more disciplined products, more diversified products, lower gearing and lower fees, so it's a different world from the hedge fund type currency products that we saw six or seven years ago. But we think those, particularly with diversification, do offer very attractive risk-adjusted returns. We see a unique combination of both the consistent return opportunities and also a whole variety of implementation approaches that aren't always available in other asset classes – particularly the opportunity to run mandates on an unfunded basis if the regulators continue to permit that, but that's a separate discussion.

» **Paesler**: I would echo a lot of what has already been said and a lot of it has to do with having lower interest rates over the last few years and the relatively small divergence between interest rates in the developed market currencies has made carry, which tends to be one of the major factors, not such an attractive bet.

I think there are also opportunities however and having technology and liquidity in the currency market allows opportunities to take positions in currencies in different ways whether it's systematic, whether it's tactical hedging by adjusting hedge ratios by currency, that sort of thing. I think that's where opportunities are rather than specific hedge fund type return seeking.

Emerging markets

» **Chair**: Emerging currencies have had a rough time of it too, partly on the back of broad dollar strength but also based on their own fragilities. Are managers taking more trades in emerging currencies or is that not a trend?

» **Paesler**: For us, from a hedging standpoint, we generally see that there are still high costs and challenges when dealing with emerging market currencies. Granted you do have a lot of deviations in the interest rates versus the developed world, so there would be opportunities there, but there are still a lot of costs around that and from a passive standpoint, what we find is that a lot of investors who don't necessarily want to hedge all of their currency exposure but a significant part of it – one strategy is to hedge all the developed and leave the emerging market unhedged just based on the cost factors alone, so that's what we tend to see happening.

» **Goodman**: There is secular growth in the liquidity of many emerging currencies. There is probably also secular growth in the weighting of emerging currencies in developed institutions' portfolios. As a result there is growing interest in both hedging solutions and in gaining exposure to emerging currencies. The difference between many emerging currencies and G10 currencies is that, unlike with the dollar/euro for example, it is more difficult to distinguish the currency decision from the market decision. So there is less rationale for passive hedging, and indeed probably less rationale for systematic hedging in general in the emerging market currencies.

» **Chair**: Do you find emerging currencies more difficult to forecast?

» **Goodman**: They tend to be structurally more volatile so it is a little bit of a different approach. There is also more of a carry effect so you have to take that into account, while it is almost meaningless at the moment in the dollar/euro/sterling/Swiss franc sphere.

» **Wood-Collins**: At the risk of challenging other preconceptions about currency, we see the emerging market currency arena as having suffered less than one might think. In terms of what we do, very few of our clients expect us to hedge emerging market currency exposure, partly because of the costs and liquidity of doing so but also more importantly it's part of the rationale

for holding those assets.

We can actually take that one step further and say, "OK, if part of the rationale for holding assets is the currency, in a way you don't need to hold the assets, you could simply hold positions in the currency" and so one can run a pure emerging market currency strategy.

There is certainly a preconception that those strategies will have performed poorly recently but a lot of that is because we are conditioned, particularly in the emerging market currencies, to think of everything as traded against the dollar. So the dollar strength looks like poor performance for emerging market currencies.

However, if you're a euro-denominated or a Japanese yen-denominated or even this year to date a sterling-denominated holder of emerging market denominated assets, you haven't suffered; that dollar strength simply isn't relevant to you. If your base currency is weakening, you're seeing those exposure currencies are strengthening and in fact we think that argument can be taken a step further – one can look at emerging market currencies against a much broader opportunity set than simply the dollar. So out of the 30-31 currencies that we see within our universe, actually 20 of those are emerging market currencies.

Passive hedging

» **Chair**: On the passive hedging side, are we seeing increasing demand from European pension funds?

» **Paesler**: We see not only demand from Europe, but globally. With the recent dollar moves, hedging is gathering increasing interest in the US and globally as well. But what we have also seen is that people are taking stronger views on currency themselves and the risk that it can bring; they're identifying it as a source of risk not necessarily a source of return. Also, we're finding that due to market regulators, and the press that currencies are getting, we're having a lot of conversations about putting on passive hedges for

"More and more of the clients we're talking to now take a more portfolio-wide view and actally want to have a balance of currencies in their portfolios"

prospects around Europe. So yes, there is increasing demand from European pension funds.

» **Chair**: Is there a particular hedge ratio that you recommend?

» **Paesler**: We don't necessarily recommend a specific ratio. It really depends on the amount of risk clients want to put on. We have some clients whose goal is just to seek out the asset classes without currency and so will do 100 per cent hedge. There are also clients who look for that regret minimisation, 50 per cent, hedge ratio, But I think increasingly if there are systematic tools and quantitative tools to be able to do a bit of a dynamic hedging strategy rather than being return seeking, it can also diverge currency by currency. But there actually isn't one specific hedge ratio we recommend or that we're seeing demand for.

» **Chair**: So you vary your advice based on the client's risk tolerance and their exposure to overseas assets?

» **Paesler**: Yes exactly. It's a combination of how much they actually have in non-domestic assets. For some, if you're seeing maybe a quarter of their exposure is non-local, then they may be willing to take on that risk and don't want to necessarily bother to put on a hedge. But it tends to come down to what part of their risk budget they want to allocate to currency. When there is a lot of volatility in currencies - and we do see that from time to time - perhaps they want to put their risk budget elsewhere and would rather remove that currency risk because it can be a very inexpensive thing to do; hedging currencies passively can be a cheap alternative to take risk off the table.

» **Wood-Collins**: We've certainly seen an evolution in terms of how clients are thinking about hedging within their overall portfolio over the last two or three years. There's a classical view, which is very asset class dependent, where you can look at volatility and that is the typical view that will often end up in 50-70 per cent hedge ratios in equities, and maybe much higher hedge ratios in fixed income where the currency contribution to volatility is that much higher.

More and more of the clients we're talking to now take a more portfolio-wide view and saying, "OK, we actually want to have a balance of currencies in our portfolio. We don't want to have everything rigidly in our base currency", particularly clients who have a less defined liability schedule, so maybe more foundations and endowments rather than pension funds. They'll say, "we look at volatility but we also look at correlations, we look at risk, we look at the asset classes that we've got, their roles in the portfolio and actually we want to get to a net position - maybe 60 per cent in our base currency but we might want to have structurally 20 per cent in US dollars, for example, because that has been a safe haven currency in past crises - that could add some useful diversification to the portfolio. We might want to keep 20 per cent in another currency for another rationale."

So I think there's an evolution in terms of how clients think about currency in their portfolios, the implementation of which then comes down to a sort of passive hedging toolkit.

» **Goodman**: One significant factor in investors' currency policies is their ability to handle cash flows. The benefits of hedging the main FX exposures seem obvious, but the one potentially significant drawback is that the FX hedging instruments will generate cash flows that will not necessarily be matched on the underlying portfolios. Therefore, depending on how liquid the portfolio is, factors as simple as whether or not you have got the team to handle the administration can drive to perhaps a surprising large extent the hedge ratio policies.

» **Paesler**: If you have a significant part of your portfolio hedged and, especially if you're using a three month or longer contract, the cash flow at the time of expiry can be significant and you need to have either that liquidity available or the underlying, perhaps passive, instruments to be able to sell off to raise liquidity. On the other hand if the hedge provides a large inflow, then suddenly you're exposed to cash drag in your portfolio and you have to do something with it, so I agree completely.

» **Wood-Collins**: Equally, we find it a very significant issue – and oddly one that clients are often more focused on than the consultants advising them. There's a view that if you have cash flows in, that's offsetting a mark to market loss on the underlying portfolio and vice versa, so one should look at it all on a mark-to-market basis. That's certainly important but actually the practicalities of meeting cash outflows on a predetermined date to a predetermined bank counterparty, the trading costs and the spreads incurred if you're selling underlying assets to meet outflows – all these practical and cost issues are very significant, so managing cash flows is a critical part of how we will try to structure a mandate for a client.

» **Paesler**: I think you're right - there are ways of managing it, you can stagger hedges so not all of the exposure expires at once, and do different length contracts, three months, one month, whatever you want to do. But we see that increasing too, especially in times of market stress when clients don't necessarily want to go to the market and raise liquidity to pay for it.

» **Chair**: It seems to be one thing that hasn't changed over the years.

Regulatory impact

» **Wood-Collins**: Change may actually be forced on us because we're all working in a market at the moment where certainly our credit-worthy clients can still trade on credit. More and more of our clients choose to use prime brokers, meeting variation margin calls, which effectively means you're paying cash flows as you go along. That can be an attractive choice for clients who want the benefit of positions in their favour collateralised. But there are various regulatory proposals as to how particularly forward contracts should be treated and if variation margin becomes mandatory on forward contracts, then we're all entering a kind of pay-as-you-go world in which cash flows are effectively accelerated; you'll be making cash flow payments potentially every day and that's a very different environment.

It's not one that we welcome either because the logistics of that will put an awful lot of pension funds off hedging and you'll end up in this odd position where a regulatory change that's intended to make the system more secure actually deters long-term prudent institutions from a sensible risk management activity because it imposes a practical burden on them.

» **Paesler**: I agree - we are concerned that any forced collateralisation or forced variation margin, especially if you look at it from a European standpoint (it's perhaps a little bit different from an American standpoint where the vast majority of assets are still USD based and a hedge isn't necessarily as big of a factor). In Europe, where you have a significant amount of non-based currency exposures that you want to hedge, it can be an issue - let's take an extreme example and say 60 per cent of your portfolio value has a hedge in place; you'll have to have say 10 per cent cash or cash equivalents available for margining, so 6 per cent of your entire portfolio will be held in cash and that is a huge drag on potential return seeking assets. So I could not agree more - putting in measures to have variation margin or collateralisation in order to reduce systemic or market risk introduces another risk - that desire for hedging could reduce and thereby expose the portfolios to currency risk.

» **Williams**: I come at all this from a slightly different point of view because I'm on a different side of the marketplace. We at Curex are seeing anecdotally far more involvement with passive hedging execution from the asset owners. They are exploring agency-type execution, largely because of the bad press the FX market has undergone in the last two years. The asset owners are realising they they need to understand more about how their execution is talking place, because they are the ones who are ultimately responsible. Going back to the points made earlier about the reasons for investing in currency, it seems to me that there's a great need for return and investors are now looking at foreign currency returns almost as an alpha-generating situation. There's a big pressure on asset owners to perform and it's not easy in this low yield environment.

The next part of all this is access and what we're struggling with now is access to instruments. There seems to be a great dearth of instruments embedded with consciously managed foreign exchange exposure. The consequence is that the market needs different types of products so that overlay managers and investors have better instruments with which to manage FX within their global portfolios. What's out there now is far too limited. We need more flexible products and I think the marketplace is creating them.

» **Chair**: What sort of products are you seeing?

» **Williams**: Traditionally, the FX market has been self-policing, however, with recent events, regulators are now looking at FX to create more transparency around pricing, with exchange-like features. We are actively engaged in conversation with product issuers

around the world who are looking to create new ways of managing FX risk at both the index and single-instrument level and we are confident that this is the tip of the iceberg in terms of new currency-sensitive investing. The products that we, at Cürex, have designed in collaboration with FTSE are exactly the type that enable product producers or overlay managers to offer greater transparency to their investors, regulators and the marketplace.

» **Goodman**: In defence of the FX market as a whole it has proven very robust, and it proved very robust even in 2008 – there were a few exceptional leaps in prices but there were no structural issues.

» **Williams**: And even more so in 2001 when we had real issues. We had a crisis in 2008 but we had a real physical structural crisis in 2001. The foreign exchange market was the only marketplace that went right the way through it.

» **Wood-Collins**: I think there is a danger that there will be unintended consequences arising from regulatory reforms. I'm sure everyone around the table agrees that the collusion and the trading against clients that has been uncovered in the WM fix is utterly unacceptable and there can be no scope for tolerating that behaviour. There is a danger though that we risk losing the message that the market, as it is structured today, can serve its users tremendously well as there is extraordinarily deep liquidity. We have a trading team which, five a days a week, 24 hours a day, can call up any one of two dozen or more banks and can get two-way liquidity at a whole range of forward dates at extremely low transaction costs in terms of spreads, and we don't want that flexibility and low trading costs to be ignored.

Of course we clearly welcome any solutions that increase liquidity and increase our choice but what we are concerned about is that we don't have some sort of infrastructure imposed on the market that will incur costs that ultimately have to be passed back to the end user of the market. There's a danger of forgetting how efficiently the market works today in a rush to reform it.

» **Williams**: I disagree slightly. Collusion is wrong in any language, but trading against your client is an emotive term. As an FX liquidity provider, if a client comes to you with an order, traditionally, you have an obligation to provide that liquidity. The conundrum now is how you provide that liquidity while managing your own risk in an environment where the rules are changing.

» **Wood-Collins**: Actually I completely agree - the reason I'm keen to say the market can serve its users tremendously well is that it does require a degree of education on the user's part as to actually what it is they're engaging in. So every time a counterparty, whether it's a pension fund or a corporate, enters into a transaction with a bank they simply have to recognise they're on the opposite side of the table from the bank and their interests therefore diverge – there's absolutely nothing wrong with that as long as people know.

One of the reasons we've had poor practice emerge is because in some cases the clients have forgotten that distinction and they've assumed that the bank counterparty owes some duty of care towards them.

» **Williams**: Most bank traders are traditionally paid to make the most they can.

» **Paesler**: There needs to be transparency - nobody's saying principals shouldn't make money on it, that's what their business is, but as long as there is information there and the end users are informed about what they're getting, what the procedure is, then fine; and if they want to have an agent step in on their behalf and shop around and provide that competitive pricing, then that solves quite a few of the issues rather than saying, "Well the FX market as a whole is broken".

» **Williams:** But the regulators, unintended as it may be, are driving liquidity-making as an art form out of business. The danger is fewer and fewer participants - we've probably got 75 per cent of the world's foreign exchange prices coming from five banks.

» **Paesler:** That's the fear because you don't want to dry up liquidity in the market because of sentiment or things like that; you're going to need this type of structural activity - you don't want to over-regulate to get you to that point.

» **Goodman:** One of the potential drivers is that end users have been very averse to paying explicit fees for the service they are getting from the market as a whole - possibly because they have not realised that they are getting that service - but if banks were charging commission on every transaction rather than acting as principals the market would be quite different.

» **Williams**: That is one of those forces that is driving a wave of business to the agency model.

» **Goodman**: Agreed. The very desirable principles of transparency and fair treatment of customers may paradoxically have the effect of not pushing them towards best outcomes.

» **Paesler**: Even if you still end up using a principal or your custodian as your currency provider, if you do have that unbundled, and at least know exactly the costs and fees you're paying for that, that provides a lot of that transparency whether you end up going to a different provider or not. I think among a lot of the people that we have talked to there is this concern about getting another provider whom they are going to have to pay fees, as opposed to right now when they are paying a bundled custody fee - so while they don't pay an outright fee for transacting currency, they do lose that transparency in terms of the spreads that they are actually paying. They don't necessarily want to pay another provider an additional fee and that's the problem.

"The regulators are driving liquidity making as an art form out of business"

In the Dutch market, where they're regulating transparency, pension schemes are going to have to report on the spreads and the FX cost and in that case perhaps it is worth paying a fee to somebody where you know the exact costs.

» **Chair**: How did the WM Reuters fixing scandal impact currency management?

» **Paesler**: One of the things it did was provide a lot of awareness around currency issues - how to trade it and what's important. It really, in my opinion, comes down to why are asset owners trading at a certain fix and it's a lot because they are benchmark sensitive or the underlying managers are benchmark sensitive; most benchmarks use the WM fix as a calculation to get returns and so if you're held to that as a performance benchmark and you don't want to incur tracking error against that, you're almost forced to trade at that price. So I think there's now a lot more awareness.

I haven't really seen too much structural change in terms of how a lot of our clients are trading. There are various changes that we've made ourselves and some of our clients have potentially moved off of it and done more of a dollar cost average around their pricing throughout the day but a lot of the issue with the WM is the allegations of collusion around something that a lot of people are forced to trade at because of the benchmark issues. So a lot of awareness has come through this but in many cases some investors may feel they were hurt because of the collusion while there are those that are going to be the opposite end of the trade that may have potentially benefitted from that collusion. So it's a very challenging issue and I don't think there is really one solution but the awareness around potential trading strategies has increased massively and I think that's a good thing.

» **Goodman**: Yes I think in the case of WM Reuters, it is not a fixing that overlay managers have desired, sought out or promoted as a group; for currency market practitioners the usefulness of using a fixing like WM Reuters is probably not as great as the desire by pension fund trustees and consultants to try to simplify the process in order to make it easier to assess whether they are getting best execution. So if you ask to trade at the fixing and measure the tracking error relative to the fixing it makes some part of consultants', service providers' and investors' lives easier but again that does not necessarily produce best outcomes. It is not something that we have particularly recommended as serving any particular bona fide useful function for the currency market per se.

» **Paesler**: I would agree with that completely and our general view is that if nobody has to trade at the fix, don't. There's no real reason to and especially if you're able to shop around for pricing and look for best pricing and then provide that transparency where the pricing is you don't necessarily need that as a measuring tool.

» **Chair**: Do you trade at the fix?

» **Goodman**: Only when clients explicitly demand it but it would not be our recommendation to trade at the fix.

» **Wood-Collins**:That's probably generally true - it wasn't created for the currency management community. It's something that's only ever been a small part of what we do and when we do trade at the fix there will often be a specific reason for it, which in many cases is because we're aligning a change in a hedge with a change in the underlying, which itself has taken place at the fix. If that's the case the client is actually trading both ways so they're indifferent to the spot price, they're buying the assets in a spot transaction, and selling the currency back at the same rate in the hedge. If you lock both transactions into the same spot reference rate really you're indifferent as to what that rate is.

We responded to the Financial Stability Board's consultation paper on this, making the point that there has been what we've termed a 'conflict of function' that has arisen around the fix. It was originally created as a retrospective view on where the market was at a particular time, so intended as an ex-post measure; it was only subsequently that the banks started offering in advance to accept orders to trade at the fix, and that is a convenience that's arisen for parts of the investment management world largely other than currency overlay managers - so a lot of passive managers in particular elect to do that.

Frankly I think that's a pretty odd thing; there are not many other markets where a bank will take an order in advance to transact at a fixed price they don't yet know - lots of people in the market think it's perfectly normal but if you look outside FX actually that's a pretty unusual arrangement. It's naïve to think somehow that you can place orders in advance, a bank will take those orders and not in any way risk manage that position. So, we see this conflict of function and the cleanest way to get rid of it would simply be to prohibit banks from accepting orders in advance to trade at the fix, but that doesn't appear to be the route that's being pursued.

» **Williams**: Also, WMR is an indicative historical rate that was designed for the mutual fund world. Then it became a great focus when asset owners were suddenly questioning the rates they received from their custodians. Now WMR is being used for a wide variety of trading and product development functions it was never originally designed for.

» **Chair**: Does anyone have any views on where they see currency management heading in the future?

» **Goodman**: We have not talked much about dynamic hedging, i.e. constrained currency management where, for example, a sterling-based pension fund has a dollar exposure in the portfolio and the overlay manager is asked to increase or decrease the amount of hedging relative to a set hedge ratio. So there would be no scope for the overlay manager to try to add value by seeking out emerging market currencies or other currency pairs that are not already in the portfolio; there would also be limited scope for the overlay manager to generate additional losses compared to what would already result from the decision to invest in the underlying assets that are being hedged. This is what we at Edmond de Rothschild have always preferred and this is very much the way the market has gone in the last few years.

» **Chair**: It's also how the market started off - more constrained currency management. We think that pension schemes should absolutely pay attention to their currency exposures. Currencies can make a huge difference to portfolio returns and that is particularly true in the next few years as we believe currency will remain volatile. We, in the global asset allocation team at Aon Hewitt, advise our pension fund clients on which currencies to hedge or leave unhedged over a medium-term time-frame.

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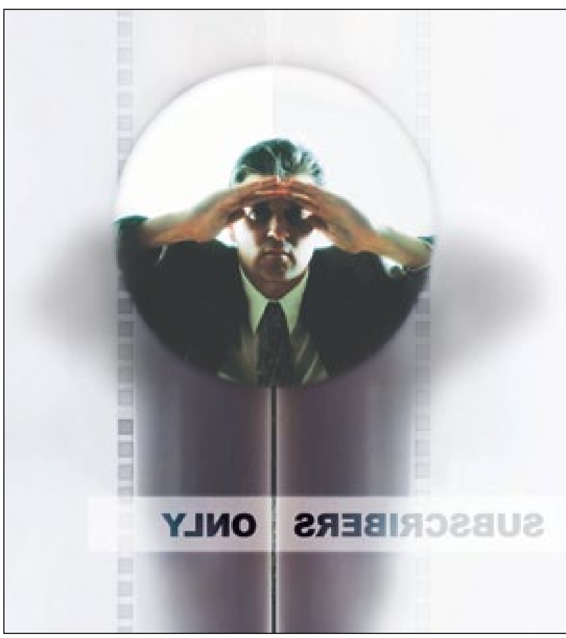

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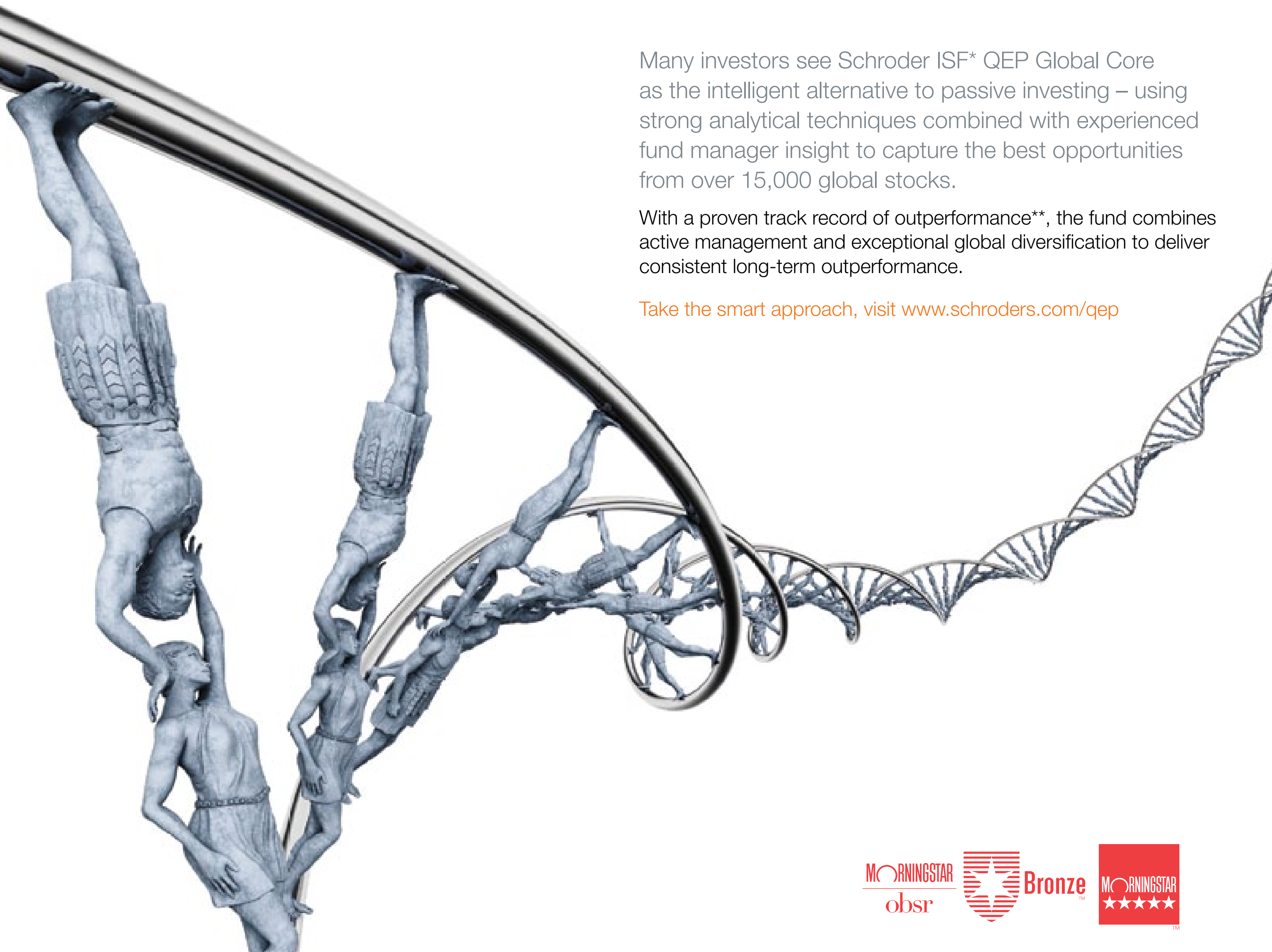

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