European Pensions

September 2017

Investment:

ESG

How pension funds should be applying the ESG criteria in their investment processes

Scheme design:

Pan-European pensions

How new pan-European pension products are planning to open up the market

Risk management:

The Netherlands

How Dutch pension funds are setting the bar high when it comes to risk-sharing

Investment:

ILS

What insurance-linked securities can bring to European pension portfolios

Protecting UK pensions

How regulation, longevity and economic factors are turning UK pension planning on its head

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Plus:

- EIOPA consultation on pensions reporting
- Pensions and Lifetime Savings Association (PLSA) interview
- PensionsEurope shares its key aims and core messages
- The role of active share

See our special supplement featuring the European Pensions Awards winners

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Pan-European pensions

This issue of *European Pensions* brings our readers details of this year's European Pensions Awards winners – ten years since the awards were first launched. Much has changed in the world of Europe's pensions since that launch a decade ago, with regulation in each country having to adjust to meet increasing longevity and changing economic conditions. One thing that hasn't developed as much as some might have hoped however is the easy operation of pan-European pensions. In recent months, however, the European Commission has published its proposal for the much anticipated PEPP (pan-European personal pension), while the European Insurance and Occupational Pensions Authority (EIOPA) launched a consultation on the creation of a EU framework for a pan-European DC occupational pension (PEOP), once again putting the issue of pan-European pensions in the spotlight.

In this month's magazine we look at what EIOPA believes is needed for the PEPP to flourish, while we also speak to the founder of a newly formed alliance - CBBA-Europe – which has at the heart of its operations the promotion, creation and development of cross-border/pan-European employee benefits in Europe. PensionsEurope also speaks to *European Pensions* this month about their thoughts on pan-European pensions as well as the wider work they are doing to "promote good pensions for the people of Europe".

ONE THING THAT HASN'T DEVELOPED AS MUCH AS SOME MIGHT HAVE HOPED IS THE EASY OPERATION OF PAN-EUROPEAN PENSIONS

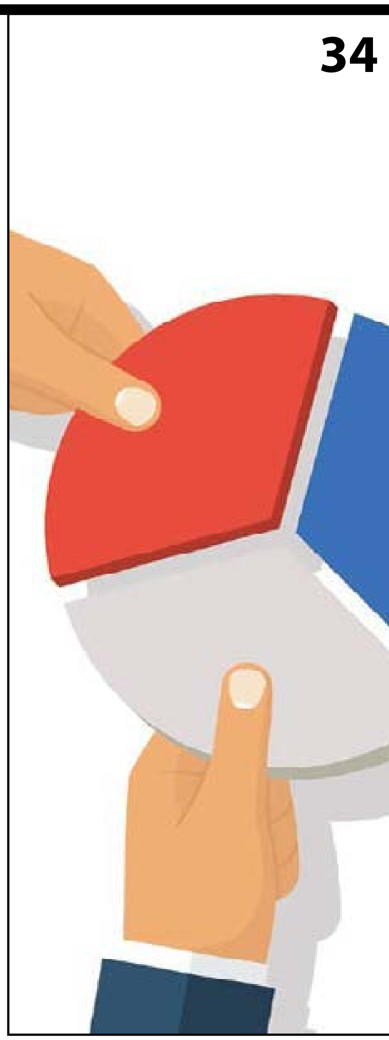
And at the end of the day, that's the key message that should prevail. The promotion of good pensions and the improvement of pension provision across Europe is what our readers expect to learn about when they pick up an issue of *European Pensions* - which country is setting the standards higher than the rest with its pensions offerings; which pension fund is implementing new ways of generating returns or communicating to its members; which providers are launching new and innovative products to lead the way. We believe this issue showcases all that and more. Happy reading.

Francesca Fabrizi, Editor in Chief

Contents

September 2017


18


34


52

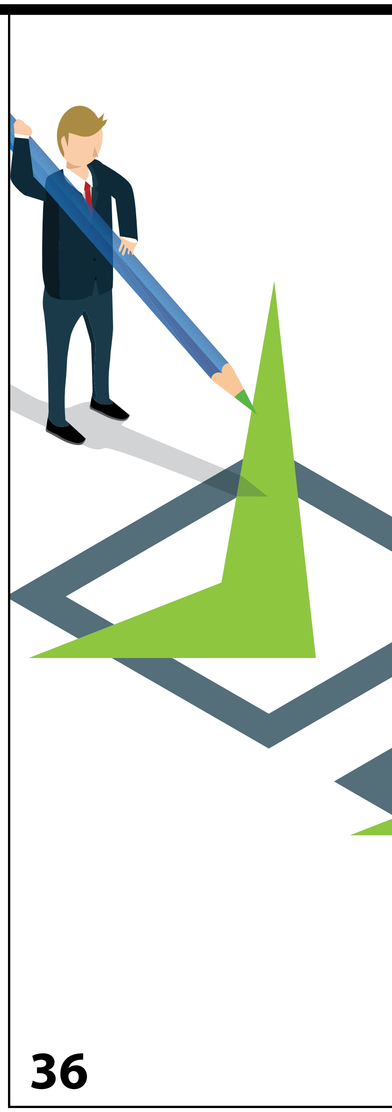
General features

Associations

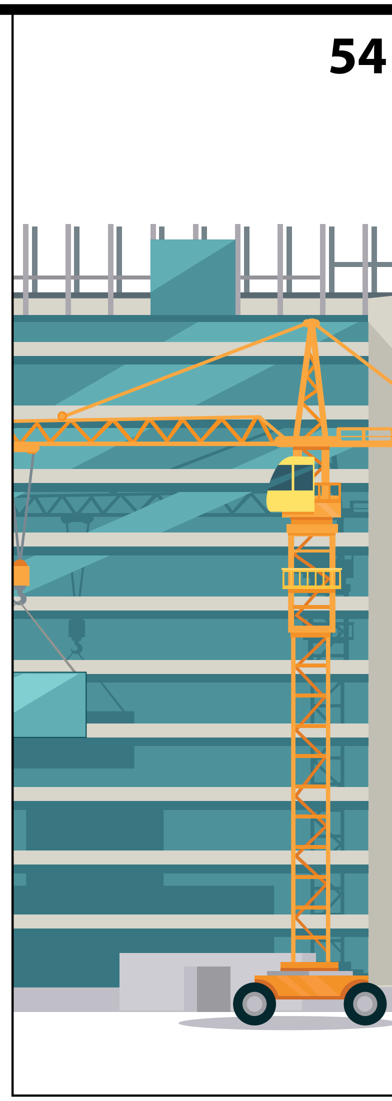
Investment

Contents

Pension scheme interview



Pan-European pensions



Regulars

EIOPA consults on plans to streamline pensions reporting

IT BELIEVES THE PROPOSALS WILL FURTHER ENHANCE ITS MONITORING AND ASSESSMENTS OF MARKET DEVELOPMENTS

Written by: Natalie Tuck

The European Insurance and Occupational Pensions Authority (EIOPA) has launched a consultation on its proposals to streamline the reporting of occupational pensions information.

The plans relate to EIOPA's quarterly and annual information requests towards the national supervisory authorities (NSAs) regarding the provision of occupational pensions information.

The aim of this initiative is to increase efficiency and to further strengthen the monitoring and analysis of the European occupational pensions sector through a single framework for EIOPA's regular information requests for the provision of occupational pensions information.

Currently, EIOPA issues regular and ad-hoc reporting requests such as the provision of information for the bi-annual Financial Stability Report, the annual Market Developments Report on occupational pensions, the annual Consumer Trends Report, the pension register, the pension database and the data gathered during ad-hoc surveys.

However, the consultation proposes a single framework, through which EIOPA would streamline all its current quantitative reporting requirements towards the NSAs. The Authority proposes one comprehensive package of reporting templates aligned with similar European and international reporting standards to ensure an efficient use of information for EIOPA and NSAs. The proposals aim to further enhance EIOPA's monitoring and assessment of market developments in the occupational pensions sector, to foster the protection of pension scheme members and beneficiaries, to undertake economic analysis and to properly analyse financial stability implications. The proposal also entails the provision of individual information of a relevant, yet fairly limited, set of Institutions for Occupational Retirement Provision.

In addition, the European Central Bank (ECB) in coordination with EIOPA has launched a public consultation about the draft regulation on statistical reporting requirements for pension funds. It aims for better quality, more granular and comparable statistical data on the sector, providing for a better understanding of its role in the transmission mechanism of monetary policy as well as of cash flows and risks associated with pension obligations.

"There is a need for better comparable and relevant information regarding occupational pensions in Europe"

EIOPA and the ECB have worked closely together on setting up the definitions and methodological framework in order to minimise the burden on the pensions industry.

Commenting, EIOPA chairman Gabriel Bernardino said: "There is a need for better, comparable and relevant information regarding occupational pensions in Europe which is decisive to take informed policy decisions."

In addition, PensionsEurope has welcomed the plans, and its chair Janwillem Bouma thanked EIOPA and the European Central Bank for the "open dialogue" on streamlining statistical reporting requirements for pension funds.

"We also welcome their public consultations and that many concerns raised by PensionsEurope have been taken into account so far. We are ready and willing to further provide our expertise to the ECB and EIOPA in order that the benefits of the new reporting requirements will outweigh the costs," he said.

The consultation on its proposals to streamline pension reporting runs until 27 October 2017 and can be viewed on EIOPA's website: https://eiopa.europa.eu

Norway maintains top ranking in global retirement index

IN TOTAL EIGHT OUT OF THE TOP 10 COUNTRIES IN THE INDEX ARE FROM WESTERN EUROPE, HOWEVER, IT ALSO REVEALED THAT EUROPE IS WAVERING ON FINANCES IN RETIREMENT, WITH SEVEN OUT OF THE TOP 10 IN THE LIST NON-EUROPEAN COUNTRIES

Written by: Talya Misiri and Natalie Tuck

Norway has maintained its position as the top performing country in a global retirement index for the second year in a row, it has been revealed.

According to Natixis Global Asset Management's 2017 *Global Retirement Index*, Norway ranked first in 2017, with 86 per cent year-on-year, with the highest score for the material wellbeing sub-index and also in the top 10 for health (3rd), quality of life (3rd) and finances (9th).

Norway's finances in retirement index grew from 72 per cent in 2016 to 73 per cent in 2017. Following Norway, eight out of the top 10 countries in the Index were from Western Europe. Switzerland was rated as second with 77 per cent in the finances in retirement index, no change from 2016. Iceland improved its overall score but remained in third place with finances in retirement rising from 68 per cent to 70 per cent year-on-year.

Sweden had an overall score of 80 per cent and ranked fourth this year, while Germany remained in seventh and Denmark eighth. The Netherlands fell one place to ninth in 2017 but improved in the quality of life sub-index.

Notably, Luxembourg moved up three spots to 10th overall, improving in the material wellbeing and quality of life sub-indices but fell in finances. The UK also dropped one place overall to 18th. While these European countries performed well overall, the finances in retirement sub-index found that seven out of the top 10 were non-European countries. This was considered as a "rarity" in regards to countries' strong performance across the continent.

Germany, Netherlands and Denmark were in the top 10 overall, but finished below 20th place in the finances in retirement sub-index. "Most European countries face an ageing population, high levels of public debt and high tax burdens, thus dragging down their scores in this sub-index," the report said. Of all the countries in the index, Luxembourg and Austria suffered the greatest drops in this sub-index, 12th to 29th and 27th to 37th, respectively, in comparison to last year.

"Finances in retirement is a particularly important index, as it reflects the strength of a country's financial system"

"The finances in retirement is a particularly important index, as it reflects the strength of a country's financial system and the ability of the government to provide for its citizens in retirement," the report added.

Following the news, the International Longevity Centre released a report that revealed French workers in their twenties will need to save 26 per cent of their salaries in order to secure a retirement replacement rate that current French retirees enjoy. According to *The Global Savings Gap*, this figure is the highest of any of the Organisation for Economic Co-operation and Development countries, and amounts to saving US$10,834 per year of working life. In addition, 70 per cent of Danish people do not know the cost of their pensions, according to research by PensionDanmark. The research, which revealed many Danish people do not know what fees they are paying towards their pensions, is "particularly worrying" as many have schemes with several companies. Its senior vice president Torben Möger Pedersen said it is worrying that such a big percentage of people do not know how much they pay for their pension schemes.

Slow uptake of Dutch variable annuities; offered by a handful of providers

THE NEWS COMES AS A DUTCH STUDY REVEALS THAT FINANCIAL EDUCATION HAS LITTLE IMPACT ON PENSION CHOICES

Written by: Ilonka Oudenampsen

Variable annuities are off to a slow start in the Netherlands, as the product is only offered by a handful of providers and few people choose a variable retirement income, research has found.

A variable annuity, which fluctuates in line with the market and interest rate, is intended to provide a solution for people with a DC pension. More than a million Dutch people currently have a DC pension and this number is expected to increase over the coming years. Individuals with a DC pension need to buy an annuity upon retirement. This used to be a fixed amount, but since last year it has been possible to buy a variable annuity.

In case of a variable annuity, the retirement income is bought on an annual basis, rather than all at once. The rest of the retirement savings will continue to be invested. Pensioners will therefore continue to profit from interest rate increases or investment returns, which could result in a higher retirement income. However, they also risk a lower income if interest rates or investments fall.

According to the paper *Financieele Dagblad*, based on research by Focus Orange, so far four commercial parties have announced to be able to provide a variable annuity, but clients generally still opt for a fixed annuity. At Nationale-Nederlanden between 5 per cent and 10 per cent of clients opt for a variable annuity. At Aegon, this percentage is already at 25 per cent. Both insurers expect a further increase in future.

"A greater number of options for pension investments often leads to no decisions and to worse decisions"

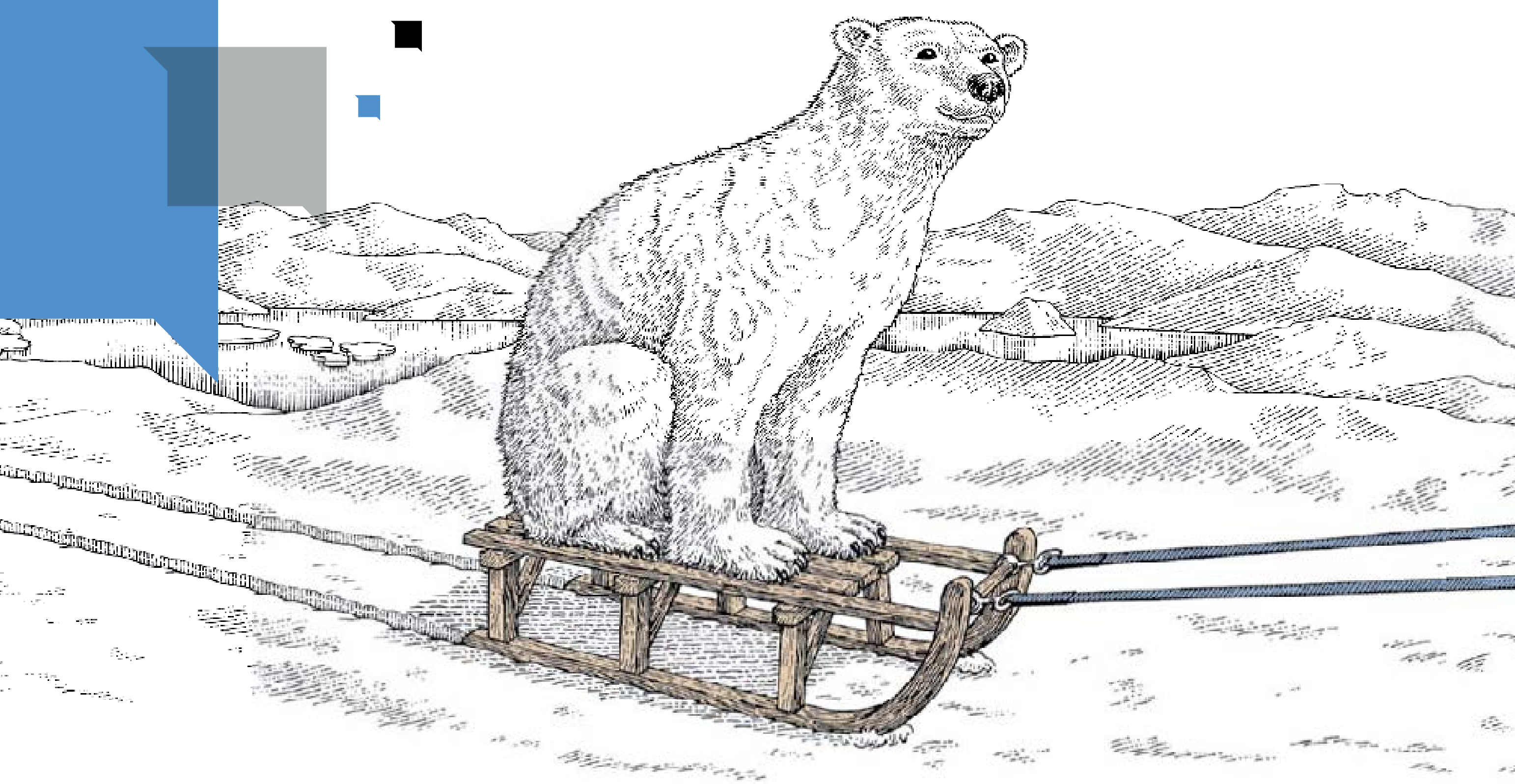
"Partly because pension providers are not or barely offering variable annuities, advisers are not discussing them much either," Focus Orange pension advisor Cindy Centen told the paper. "That's why most people who are retiring are unaware of the option and therefore don't ask for a variable annuity."

The news comes as another Dutch study found financial education barely has an impact on the pension choices of Dutch consumers. Instead, pension providers should limit the number of complex choices and appeal to emotions, research institute Netspar has said based on literature research and an international comparison.

Netspar noted there is very little scientific basis for the theory that financial education leads to better pension choices. "A greater number of options for pension investments often leads to no decisions and to worse (less deliberate) decisions. Furthermore, it seems people are often (unconsciously) following their intuition, especially if they feel the choices are complicated. The feeling evoked by language has a great impact on this. On top of that, people systematically postpone saving for retirement and they are sensitive for what is being offered as the 'silent choice' (silence implies consent)."

Language plays a major part in the choice consumers eventually make, the research institute said. For instance, the use of the word 'important' seems to have a negative impact on the attention people pay to pension communication.

"The explanation is that this word is being associated with something difficult and time consuming, which results in people deciding to look at it later, but which is then often forgotten." Netspar said that it is essential that pension providers and boards of pension funds that shape pension choices take into account how people make decisions. "Only then can freedom of choice create the added value that it could offer."



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News in brief

■ The **Swiss fund market** has broken through the CHF 1trn barrier for the first time, following an increase of CHF 30bn (3 per cent) over the month, latest statistics have revealed. According to Swiss Fund Data AG and Morningstar, during July 2017 funds reached CHF 1,013.4bn, driven primarily by market-related factors. This is up from CHF 983.2bn in June. Net inflows totalled around CHF 7.5bn in July 2017. "Buoyed by the positive performance on the financial markets, the Swiss fund market broke through the one trillion barrier for the first time in July," said SFAMA managing director Markus Fuchs.

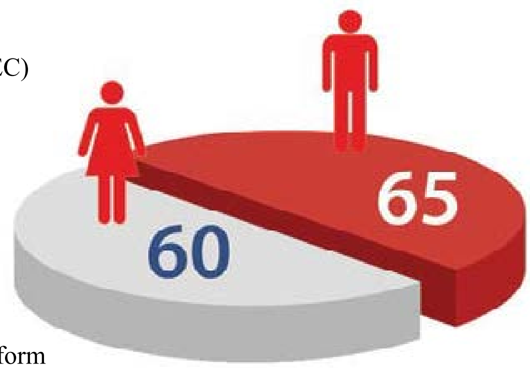
■ **Norges Bank Real Estate Management,** on behalf of the Norwegian Government Pension Fund Global, has acquired a 100 per cent stake in a property in central Paris. The property is at 6-8 boulevard Haussmann, and the agreement was signed 28 July 2017 and is scheduled to close before year-end 2017. Norges Bank Real Estate Management has agreed to pay €462.2m for the property. No financing will be used in the acquisition. The property comprises 24,500 square metres of office space.

■ Earnings-related pension insurance companies **Ilmarinen Mutual Pension Insurance Company** and **Etera Mutual Pension Insurance Company** are to merge at the beginning of 2018, it has been revealed. After the merger, the company will administer the pensions of a total of 1.1 million individuals, with more than 675,000 insured and 460,000 retirees making it the largest private-sector pension insurer in Finland.

European Commission concerned over Poland's retirement age plans

POLAND'S PLANS ARE IN CONTRAST WITH IRELAND, WHICH HINTED AT PLANS TO INCREASE THE STATE PENSION AGE

Written by: Natalie Tuck



The European Commission (EC) has expressed its concerns over Poland's plans to reintroduce a different retirement age for men and women in the country.

According to a letter from Brussels to Warsaw seen by *Reuters*, the EC has noted that Poland's plan to undo a 2021 reform to raise and equalise the retirement age to 67, could violate the Union's equality rules.

Ruling Law and Justice Party (PiS) and President Andrzej Duda's plans will reintroduce a retirement age of 65 for men and 60 for women to come into force from October this year. Poland's deputy Prime Minister Mateusz Morawiecki defended the move, stating that women should be permitted to retire earlier as they have more responsibilities, such as raising a family.

"What we propose reflects not only social expectations but also different roles for women, different roles for men," Morawiecki told *Catholic Trwam* television. However, EU officials for Justice and Gender Equality Vera Jourova, and Employment and Social Affairs, Marianne Thyssen, in a letter to Poland's Labour Minister, Elzbieta Rafalska said: "Equal treatment between women and men is a key pillar on which our Union is based," and that the changes in the Polish system could be 'incompatible with EU law'.

Also responding to Poland's decision, economists have opined that the move will hit growth and public finances, among a backdrop of increased state spending. This case is not the first disagreement between Poland and the EU - PiS previously clashed with the Union over democratic principles, migration and the large-scale logging of the primeval Bialowieza forest, Reuters noted.

In a contrasting move, Ireland's Social Protection Minister Regina Doherty has hinted at a rise in the state pension in the next budget. According to *Breaking News Ireland*, Doherty has said that there may be a rise in the state pension later this year.

Doherty also recognised that others may need more financial assistance than pensioners: "I'm very conscious of the fact that there are other people who are far more vulnerable in society than pensioners. Lone parents at the moment are probably the most vulnerable people in society. Children are at the highest risk of poverty in this country with 20 per cent of our children in deprivation levels. That to me is very important, that needs to be addressed."

News in brief

■ **Nigeria**'s pension funds, which currently stand at N6.5trn, are faced with a major threat of depletion due to the multiple bills sponsored by some persons and bodies at the National Assembly, the National Pension Commission (PenCom) and the Pension Fund Operators Association of Nigeria (PenOp), have said. As reported in *The Nation* speaking in Abeokuta, Ogun State, PenOp said the current pension administration may take a downward turn if the bills numbering over seven become law.

■ **Canadian** defined benefit pension plans saw gains in the second quarter of 2017 despite the weakening of domestic equities, according to RBC Investor & Treasury Services. While Canadian equities saw a loss of 1.9 per cent, total pension plan returns for the second quarter of the year were 1.4 per cent *The insurance and investment journal* has reported. The decline mirrors that of the TSX Composite Index which saw a loss of 1.6 per cent for Q2 2017, down from gains of 2.4 per cent in the last quarter.

■ A **Japanese** politician has proposed that wealthy pensioners give up their old age pensions as a way of dealing with Japan's demographic crisis, *The Times* has reported. Politician Shinjiro Koizumi has proposed to invite well-off people to give up their pensions in order to fund nurseries to allow working mothers to return to work. Japanese politicians acknowledge the need to reform society to ward off the "silver tsunami" of growing welfare costs. A quarter of Japanese people are over 65 and the proportion of elderly Japanese is expected to rise to 40 per cent.

Middle East pensions need reform - AMF

WORLD BANK REPORT HIGHLIGHTS THAT PENSION SYSTEMS IN THE ARAB REGION NEED URGENT ATTENTION

Written by: Natalie Tuck

There have been calls for "urgent" reform of pension schemes in the Middle East by the World Bank and Arab Monetary Fund (AMF).

Gulf News Dubai reported that as most countries of the Middle East and North Africa set up their current national pension schemes in the 1970s, the AMF believes because little or no reform has happened since, there is an urgent need of sustainable reforms. A recent World Bank report *Pension systems in the Arab region: Trends, challenges and options for reforms* shows why pension reform is needed and why it is urgent.

The authors of the report have highlighted six general problems with pension systems in the region: The pension promise is large and unaffordable; schemes are financially unsustainable; badly designed rules introduce unnecessary distortions in labour supply and savings decisions; the schemes are fragmented and administration is weak and costly; coverage rates are modest, with important gaps among the self-employed and in rural areas; and governance structures are not designed to ensure that the funds are managed in the best interests of plan members.

US pension plans at risk of insolvency due to underfunding

LONG-TERM CONSEQUENCES FOR THE US COULD BE FAR-REACHING

Written by: Natalie Tuck

Around 114 multi-employer pension plans in the US, covering 1.3 million people, are underfunded by more than US$36m and are expected to become insolvent in the next two decades, according to a new report by Cheiron.

The Washington Examiner reported that although the plans cover just 8 per cent of the 1,400 plans of the same kind in the country, the report warns that the consequences of the failing plans could be bad for the rest.

"Traditionally, participants in healthy multi-employer pension plans have been forced to pay for the guaranteed benefits of retirees and their families in failed plans," Cheiron principal consulting actuary Joshua Davis said. "If this happens again, it will push other plans into insolvency with terrible consequences for communities across the country."

Multi-employer plans involve several companies and unions jointly managing a pension fund for all of the workers.

Cheiron noted that three plans — the Teamsters' Central States, the Bakery and Confectionary Workers Union, and the United Mine Workers — account for $22.8bn, about 62.5 per cent, of the unfunded liability. Those plans cover 603,000 participants.

Irish Pensions AWARDS 2017

23 NOVEMBER 2017

5* Shelbourne Hotel Dublin

SHORTLIST ANNOUNCED

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- organised by European Pensions

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NEW IRELAND ASSURANCE

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 talya.misiri@europeanpensions.net

ALAN SCHOFIELD

Local Pensions Partnership has named Alan Schofield as non-executive director of the board, representing shareholders of the Lancashire County Council. He will be one of two shareholder non-executive directors on the board and will also serve as a member of the Remuneration and Nomination Committee. Schofield was elected to the Council in 2013 and is the deputy chair of the Pension Fund Committee at Lancashire County Council.

PETER LAURENCE

Trafalgar House has appointed Peter Laurence as senior pensions associate. Laurence joins from Willis Towers Watson where he had been pensions coordinator since 2013. He has an extensive background of almost 15 years' experience in pensions administration and has held roles at Capita Employee Benefits, Aspen Actuaries & Pension Consultants and Paymaster.

JOSH HUGHES

Muzinich & Co has announced the promotion of Josh Hughes to head of global distribution. Formerly managing director of marketing and client relations, Hughes will now focus on key international accounts as head of global distribution. He will coordinate the firm's regional European offices to support and develop business with the company's partners.

LUKSHMI SELVARAJAH

Capital Cranfield has appointed Lukshmi Selvarajah as a professional trustee. She will take on the role in September and will be based in Scotland. Selvarajah joins from Deloitte where she spent five years, responsible for the firm's employer covenant advisory services in Scotland. Before this, she held positions at EY and PwC in corporate finance and restructuring roles. She holds degrees in economics and investment management.

SEAN BURNARD

Law Debenture Pension Trustees has welcomed Sean Burnard as a trustee director. Burnard joins from Vendian Investment Management LLP where he was COO of the family office team, responsible for private assets and hedge fund allocation. Burnard spent 12 years as an investment professional followed by 10 years as an actuary. He served as an actuary and consultant at HSBC.

GLENN BROWN

KAS BANK has appointed Glenn Brown as senior relationship manager. Brown will be responsible for building long-term relationships with the firm's UK pension fund clients. He joins KAS BANK after an 18 year career at Northern Trust, where he was client relationship manager for the Institutional Investor Group. He has also worked at Lloyds Bank Securities Services.

LORRAINE HARPER

The Pensions Management Institute has appointed Lorraine Harper as co-vice president. After nearly 40 years as a member of the PMI, Harper will work closely with newly appointed president Robert Branagh and co-vice president Lesley Carline. Harper has been a director at JLT Employee benefits since 2011 and has also served at KPMG and the Ministry of Defence. She joined the PMI in 1979 and was made a fellow in 1991.

HOWARD MAHON

Muzinich & Co has hired Howard Mahon as director, pan-Europe private debt. He will be based in the firm's new Dublin office and will look to expand private debt capabilities and grow a team dedicated to the Irish market. Mahon joins from the AIB where he was an associate director in the bank's specialised finance unit. Before this, he worked at Deloitte & Touche.

SIMON DAVIES

HSBC Global Asset Management has hired Simon Davies as sales director, UK pensions. Davies will be responsible for working with prospective pension fund clients in the UK to deliver investment solutions in both DB and DC. He will be based in London and report into head of UK institutional Adrian Gordon. Davies joins from Standard Life where he was corporate relationship director.

NICO ASPINALL

B&CE, provider of the People's Pension, has appointed Nico Aspinall as chief investment officer. Aspinall will lead the investment management team to support the board and trustees in driving investment strategy. He has a wealth of DC investment experience, providing consultancy services to a number of high profile clients. Before this, he spent four years as head of DC investment consulting for Willis Towers Watson UK and in DC at Barclays Bank.

DAMON HOPKINS

P-Solve has hired Damon Hopkins as associate director.
Hopkins joins from Willis Towers Watson and will work in P-Solve's DC Investment Consulting practice to support the team's growth and innovation. He will report into P-Solve co-head Ajeet Manjrekar. Hopkins previously advised trustee and corporate clients on DC issues at Willis Towers Watson.

Diary dates 2017

The latest events occurring across the European pensions scene

MONEYAGE AWARDS
12 October 2017
Millennium Hotel, London

Now in its exciting second year, the MoneyAge Awards celebrate excellence, professionalism and innovation in the hugely competitive but critically important UK personal finance space. Honouring the banks, building societies, savings and investment providers, mortgage companies and personal finance specialists that have proved themselves ahead of the game in the field of consumer finance, these awards are free to enter.
moneyage.co.uk/awards

PLSA ANNUAL CONFERENCE 2017
18-20 October 2017
Manchester Central Convention Centre, Manchester

The way we live, work, save and retire will never be the same again. The discussions at the PLSA Annual Conference and Exhibition will help delegates to decode the future – to understand the forces shaping it and how to respond to them. The annual event includes keynote speeches, streamed focus sessions, fringe meetings, a Trustee Learning Zone, networking events and an exhibition.
plsa.co.uk/Conferences_and_Seminars

PENSIONI & WELFARE ITALIA
26 October 2017
Hotel Quirinale, Rome

The Pensions & Welfare Italia and Italia Assicurazioni Awards aim to promote excellence in the pension and insurance sectors. The prestigious trophies are intended for those pension funds, consultants, insurance companies, brokers and other operators in the industry who are able to offer the best professional standards. The winners will be announced at the Pensioni & Welfare Italia Awards and Italia Assicurazioni Awards gala dinner.
Europeanpensions.net/italiaawards/

Not to miss...

PUNTER SOUTHALL ANNUAL PENSION CONFERENCE
28 September 2017
BAFTA, Piccadilly, London
puntersouthall.com/pension-events/

INSIDE ETFS EUROPE
23-25 October 2017
Hilton Park Lane, London
Finance.knect365.com/inside-etfs-europe/

PROTECTING MEMBERS KEY STEPS TO CYBER SECURITY
10 November 2017
Fenchurch Street, London
Pensions-pmi.org.uk/events/

IRISH PENSIONS AWARDS
23 November 2017
The Shelbourne Hotel, Dublin
Europeanpensions.net/ep/events

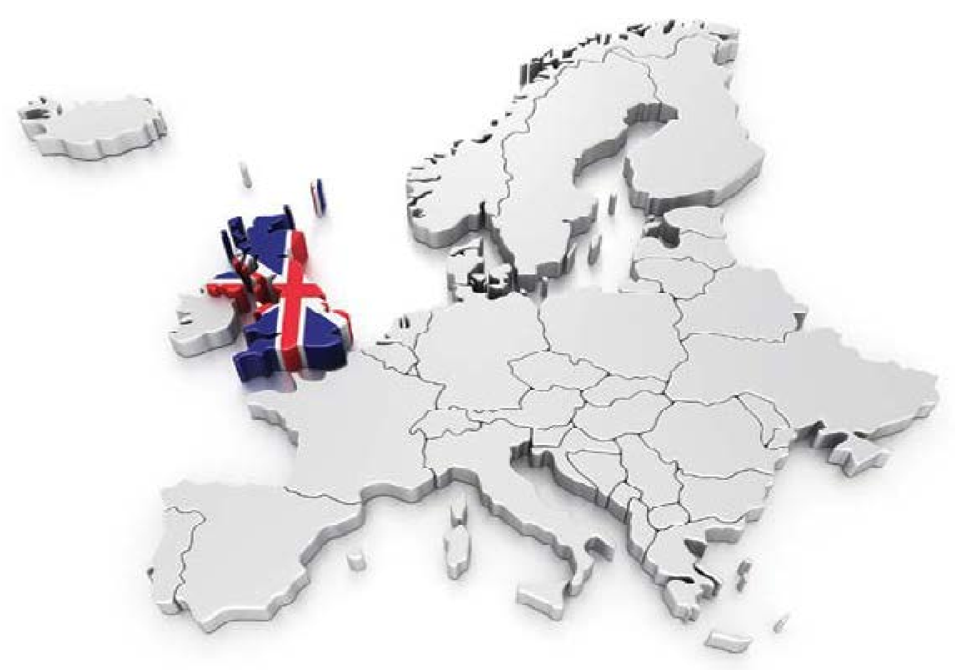
If you have any European pensions events to promote, please contact talya.misiri@europeanpensions.net

COUNTRY SPOTLIGHT | UNITED KINGDOM

Protecting UK pensions

Longevity and the proportion of GDP needed to pay for government retirement provision in the UK has resulted in a dramatic rise in the state pension age. This could wash away the traditional transition from work to retirement and leave many with a financially precarious old age

WRITTEN BY MAREK HANDZEL



In July this year, the UK's Work and Pensions Secretary, David Gauke, announced that the state pension age was to rise from 67 to 68 from 2037, seven years earlier than had originally been planned.

The news was not unexpected. Firstly, a report on the matter released in March by Sir John Cridland, the former director-general of the Confederation of British Industry, recommended an earlier increase. Secondly, the new minority Conservative government found itself in a financial pickle following the surprise General Election in May.

In return for propping up Theresa May's minority administration, Northern Ireland's Democratic Unionist Party (DUP) demanded that she keep the so-called state pension triple lock: a guarantee to increase the state pension every year either by a minimum of 2.5 per cent, the rate of inflation, or average earnings growth, depending on which of the three is highest. During the election campaign the Conservatives had talked openly of dropping the expensive promise. Having now preserved it, the only option in the age of austerity was to postpone the date from which people can receive it.

The UK's state pension age has undergone a huge overhaul since 2010. Rising from 60 to 65 for women between then and 2018, it has also been pencilled in for future increases to 66, 67 – and now 68 – for both men and women.

Old Mutual Wealth's head of retirement policy, Jon Greer, says that the government's latest decision to change the timetable for increasing the state pension is proof that it is taking a gradually declining role in supporting retirement income.

"A combination of increases in life expectancy, and the growing number of retirees relative to the working age population, means that individuals will have to save harder for their own retirement," says Greer.

The demographic group immediately affected by the decision is that of workers aged between 39 and 47. The Pensions and Lifetime Savings Association's director of external affairs, Graham Vidler, recently referred to this group as the "sandwich generation". He argued that they were at the most risk of inadequate private saving: not only had they not had the same access to defined benefit pension funds as

THE GOVERNMENT'S APPARENT SLOW WITHDRAWAL OF STATE SUPPORT HAS NOT GONE UNNOTICED AMONG THE GENERAL PUBLIC

their parents, but they were also too old to experience the full benefits of automatic enrolment.

Vidler called on the government to pick up another one of Sir Cridland's recommendations – providing access to a midlife financial check-up. This could help people who need to work longer before they receive their state pension make "smarter financial choices to boost their savings," he said.

Impact on the pensions system

But it is not just the "sandwich generation" that is of concern. The government's apparent slow withdrawal of state support has not gone unnoticed among the general public, according to The Society of Pension Professionals' president, Hugh Nolan.

"We do get a sense of people saying that they can't rely on the government to provide them with a decent pension," he says.

"So my suspicion is that this will increase people's awareness of pensions and get them to save a bit more. On the grounds that if they want to retire at 65 rather than 68, then they'll think, 'I need to put a bit more aside for myself'.

However, he says, there is also a risk that some people will throw their hands up in horror and say: 'Forget it, I'm just going to die'.

Realising that they cannot rely on the government for a decent pension income, and throwing in the towel on their own prospects of being able to support themselves in retirement, these people will stick their heads in the sand and just hope for the best, predicts Nolan.

"So there will be the two groups. People who have a bit of money and are financially savvy will probably put a bit more aside. And the ones who have nothing at all, who need to save the most out of everyone, will be the ones who don't do anything at all."

This could also create a further class divide, says Nolan.

"Middle class professionals who sit in an office doing a job might well carry on working and saving until they're 68, whereas your working class people who are doing physical jobs are going to find that more physically challenging."

Uncertainty

The Pensions Management Institute's technical consultant, Tim Middleton, has noticed another possible trend that could create a dangerous rupture in the savings space. He says that the Institute has already noticed a pronounced trend of people decumulating early, particularly within defined contribution schemes.

"If that's going to continue, then

PEOPLE APPEAR TO BE PLANNING FOR A PHASED RETIREMENT

they're going to be less likely to think about pensions as something for old age, and more something that they access in middle age.

"Pushing the state pension age back is going to divorce private saving from state pension provision, and that could create some problems later on," he warns.

Part of the reason for early access of pension pots, made easier by the previous government's relaxing of the rules, is that the UK public has very little confidence in the integrity of its pension system.

"We only very recently had announcements about the deficits affecting DB pension schemes, and that's likely to encourage moods of cynicism over the capacity of occupational schemes in particular to honour benefit promises to members," says Middleton.

His argument is backed up by a recent poll conducted by The People's Pension, a master trust pension provider, which found that 52 per cent of UK adults expect that their financial situation will not support their desired lifestyle in retirement. It also estimated that more than eight million adults under the state pension age expect to work part time to support themselves once they retire.

Speaking about the results in August, The People's Pension's director of policy and market engagement, Darren Philp, said that the concept of people completely stopping work and relying on their pension savings had been consigned to history in the UK.

"Instead, people appear to be planning for a phased retirement, where they may choose to work part-time, or surviving on sources such as an inheritance or property," he said.

The fact that so many people are resigned to a partial retirement is something that the pensions industry needs to tackle, says Middleton.

"We need to restore public confidence. And to persuade them that this is a system that provides for them in their old age," he says.

Future rises

Whatever happens in the private space, the disconnect between state provision and people's financial needs in old age is, as matters stand, set to grow in the UK.

Nolan says that with the existing state-of-play, the share of GDP needed to pay for state pensions is going to have to go up from 5 per cent to 7.1 per cent over the next 40 years. Healthcare and social care are also estimated to account for another 5 per cent increase in GDP.

"The ageing population is likely to be costing an extra 7 per cent of GDP over the next 40 years, which is a frightening prospect," he says.

To reverse this drain on the public purse, Nolan says that some very difficult discussions about taxation may have to take place if the state pension age is to not go over and beyond 70.

"We either have to start cutting back on pensions and making people retire later, or we have to start making people pay substantially more tax to be able to cover the costs."

By Greer's reckoning, this will be an unpalatable scenario for any future government. The only solution to reduce costs, therefore, is to deal with the triple lock, once the DUP are out of the main political picture.

In place of it, Greer believes that the government should consider a smoothed earnings link, as recommended by the UK's Parliamentary Work and Pensions Select Committee last year.

"This allows growth in pensions to continue, but when earnings fall behind price inflation, an above earnings increase could apply until either earnings growth catches up with inflation, or for as long as the pension remains above a previously established limit compared to average earnings.

"When this happens, it would revert to earnings. This would ensure that the state pension rises in line with earnings, rather than faster than earnings, and also protect pensioners when earnings fall." ■

PLSA

Building a connection

JAMES WALSH OF THE UK'S PENSIONS AND LIFETIME SAVINGS ASSOCIATION REVEALS HOW THE COUNTRY'S PENSIONS INDUSTRY IS ATTEMPTING TO IMPROVE ENGAGEMENT

Telling people I work in pensions usually elicits a curious mixture of mild disappointment and genuine interest. Disappointment, because there is a view that pensions are dull and rather complicated. But interest, because people know pensions matter to them personally and would quite like to have someone explain things to them.

In fact, the initial frowns are usually followed by a series of questions and – if I'm lucky – by 'I wish someone had explained it to me like that before'. What these conversations tell me is that there is a genuine thirst for information about retirement saving, presented in a user-friendly way. And it's down the UK pensions industry to do something about it, with a little bit of help from the government and regulators as well.

Pensions dashboard

The pensions dashboard lies at the heart of the UK's work on helping people to engage with their savings. We know it can be done, as the Netherlands, Sweden and Norway already have fully functioning dashboards. We just have to apply their experience to the UK's rather more diverse pensions landscape. Simple!

The current pensions dashboard project kicked off when then Chancellor George Osborne used his 2016 Budget to ask the industry to build a comprehensive pensions dashboard, with a prototype ready for April 2017 and implementation by 2019.

The ABI has project-managed the first stage – development of the prototype - for HM Treasury and on behalf of the wider industry. The project has been funded by a variety of providers including single-employer schemes, insurers and master trusts. It worked quickly to demonstrate that data could be shared between schemes in a quick and secure manner. Once the concept had been proved it was essential to analyse the impact it would have on consumers and the cost it could represent for industry. Additionally, work is being undertaken on the data standards and product specifications that will form the underlying architecture.

If delivered in the right way and implemented with proper regulatory safeguards, the dashboard should help us to achieve the improved engagement and understanding that people clearly want.

Automatic enrolment review

One of the reasons we need a pensions dashboard is that more people are saving in pensions. The UK's introduction of automatic enrolment has been a great success, with 8,314,000 people auto-enrolled at the last count, but there is more to do to ensure that as many people as possible feel the benefits.

The auto-enrolment programme started with low contribution levels and a focus on people in full-time employment. The PLSA supported this approach: high levels of initial contributions might well have scared off new savers and using workplace pensions as the perfect delivery vehicles meant full-time workers were the obvious group in scope.

However, we now need to start thinking about those who are missing out and the PLSA has argued for including the following groups:

1. Younger people, who would save more and benefit from greater accumulation if they began saving at age 18;
2. Self-employed people, who are unlikely to be saving into a pension; and
3. Low earners with total earnings in excess of the trigger (£10,000) from more than one job.

We also believe it is essential, in order for everyone to have a comfortable income in retirement, to raise minimum contributions to at least 12 per cent of band earnings at some point in the future.

If we can move auto-enrolment forward and deliver the dashboard as well, then people in the UK will have bigger pension pots and better information about them. Suddenly those 'What do you do?' conversations might start in a better place. ■

Written by James Walsh, policy lead: engagement, EU and regulation at the Pensions and Lifetime Savings Association

INTERVIEW

Kingfisher Pension Scheme: setting the bar high

Talya Misiri speaks to Matt Fuller and Banafsheh Ghafoori at the Kingfisher Pension Scheme about its scheme communications, education programme, investment strategies and de-risking success

WRITTEN BY TALYA MISIRI

Can you outline the make-up and structure of the scheme?

The Kingfisher Pension Scheme is a hybrid scheme, providing final salary benefits for employees who joined the Scheme before 1 April 2004 up until the closure to future accrual on 30 June 2012, and money purchase benefits for all employees recruited on or after 1 April 2004. The final salary assets currently stand at £3.2 billion, the money purchase assets stand at £260 million.

Its aims are to represent the interests of its members, trustees and participating employers and to educate members of financial awareness and scheme benefits towards a lifestyle they would like at retirement.

What would you say have been the scheme's biggest successes to date?

Member Education

The trustees and the employer recognise that investment is only one element in achieving good member outcomes and that there are a number of other more influential factors such as: what benefits the members have, the level of education, the type of retirement options chosen, etc. So a five year 'saving for your future' programme was created in 2012 and further enhancements to the scheme's in-house annual benefits statement have helped members make informed decisions. It is now in its final year where engagement and innovation has continued. For example, 2015 saw the launch of the scheme's innovative and engaging pensions app.

DC Investment Strategy Review

The trustees felt that a scheme specific objective was required that would be applicable to the scheme's membership demographics and contribution structure. Having set the objective, the trustees were able to work through the different factors and understand what they needed to target through investment returns. Without having a clear objective it would be hard to determine whether the risk return profile was appropriate.

DB Investment Strategy Review

Following the completion of the 2013 valuation, the trustees reviewed the scheme's matching assets and completed a number of changes focussing initially on the LDI programme and hedging before reviewing and transitioning the fixed income mandate. These developments saw a transition, and realignment, of some £3billion of assets.

Can you explain the scheme's investment strategy?

On the DB side of the scheme the overarching objective is to be fully funded on a self-sufficient basis by 2030. On the DC side of the scheme the objective is to target two thirds of the members' final salary upon retirement, recognising that for most of our members, who are relatively low earners, the state pension will constitute the largest part of their retirement income.

The Kingfisher scheme has been praised for its risk aversion on both the DB and DC side, would you say this is a main, continued priority?

Certainly de-risking has been a key element of the DB investment strategy over the years, but it's not just about risk aversion and avoiding risk - rather it is about addressing risk in the most appropriate way. On the DB side of things that may be through increasing hedging levels or introducing more diversification to returns seeking assets, whereas on the DC side of the scheme it may be about ensuring there is a sufficient level of risk taken during the growth phase but aligning the de-risking phase with the state retirement age. Most members will not be able to afford to retire until they reach state pension age, so to set members up to de-risk fully by age 65 and potentially invest in cash funds for two or three years before they retire (with the state pension age moving up to 67 and 68) no longer feels appropriate either.

Can you explain the Bolt To The Finish app? Has it had an impact on members?

Bolt to the Finish is an endless runner game that will communicate the importance of saving for your future. The coin collection game demonstrates that the earlier you start saving, the better via the choice of character and the obstacles faced. The app then allows us to integrate and direct all the educational material to the user at the end of each play.

Can you give an overview of the scheme's member communications strategy?

In 2013, the trustees confronted the challenges of communicating and educating with their audience by introducing and launching their five year education programme entitled 'Saving for Your Future'. Since the launch, and with the help of friendly characters that the target audience could relate to, "the Bolt Family" has been an outstanding success, creating an ownable creative platform that works across different media channels. Pension awareness levels have exceeded expectations by increasing to 75% and opt out rates are currently at an all-time low of 3%.

After extensive research analysing the scheme's member demographics and their current understanding of pensions, the trustees realised that employees thought pensions should only be considered later in life. It was also evident there was a widespread lack of interest and understanding of pensions. Moreover, the communication challenges for the task were unique, given multiple store and branch locations, employees working diverse shift patterns and most store employees not having access to PCs during work. For many, it was a lack of confidence rather than unwillingness that stopped people saving. Communications needed to stand out and engage.

DE-RISKING HAS BEEN A KEY ELEMENT OF THE DB INVESTMENT STRATEGY, BUT IT'S NOT JUST ABOUT RISK AVERSION AND AVOIDING RISK - RATHER IT IS ABOUT ADDRESSING RISK IN THE MOST APPROPRIATE WAY

Although the initial phase has been proven to be a success the trustees understand that these challenges are on-going, especially given the recent pension reform announcements effective from April 2015. In 2014, the trustees continued to develop the series of pension education modules further to explain changes and options to employees. With the help of the Bolt family, these became relatable and engaging 3D educational videos, leaflets, downloads and presentations, to be used in-store, at home and online, thus bringing the pension education campaign to them.

Moreover, the trustees decided to take a step further and created an innovative app built to drive engagement and awareness with the key target audience. With almost 90% of people aged 18-25 owning a smartphone, research showed people aged between 16-24 years were the biggest gamers.

The trustees also understood, in the fast moving world of pensions, communications would need to continue to evolve. To accommodate the new modules, the trustee's website was revamped to be clearer, simpler, user-friendly and mobile friendly. ■

Matt Fuller is pension investment manager and Banafsheh Ghafoori is pensions technical & communication manager at Kingfisher Pension Scheme

SAVING FOR YOUR FUTURE

INTERVIEW

Opening the doors

Francesca Fabrizi meets Francesco Briganti, Secretary General of the Cross Border Benefits Alliance-Europe to discuss the aims and objectives of this new initiative, and how it could impact the future of cross-border pensions

WRITTEN BY FRANCESCA FABRIZI

What is the Cross Border Benefits Alliance-Europe?

The Cross Border Benefits Alliance-Europe (CBBA-Europe) is a new EU-based advocacy organisation. Its goal is to promote the creation and development of cross-border/pan-European employee benefits in Europe, including - but not limited to - occupational (workplace) pensions, healthcare, disability, long-term care or programmes for the well-being/wellness of people in the workplace and private life.

Is it different to other initiatives?

CBBA-Europe is an international association subject to Belgian law, as are the majority of EU-based industry federations. However, unlike the traditional industry federations representing a given sector or industry, CBBA-Europe will welcome a whole range of different members - employers/company sponsors operating in several member states of the EU (multinationals); sector-wide employee benefit funds, including representatives from the employer and worker sides; insurance, mutualistic and bilateral social protection (benefits) providers; the social protection industry such as pension or healthcare funds administrators, actuaries, lawyers or consultants; academic representatives; consumer organisations; national and international associations representing companies, social protection funds, professionals in the field, etc.

In short, the Alliance aims to be transversal, and hence more credible: all those pursuing the same goal of advocating the EU and its member states to remove the existing obstacles to cross-border employee benefits, be they of legal, taxation, administrative or political nature, will be welcome.

CBBA-Europe will interact with the EU Institutions, national governments and supervisory authorities, by raising questions on behalf of its members, and proposing practical solutions. The first institutional goal of the Alliance is to be recognised as an influential, valid and constructive interlocutor of the decision-makers, by participating in working groups, drafting reflection papers, creating reports, organising public events and so on.

Why is developing cross-border pension/social benefits so important?

The current national barriers to the creation of cross-border employee benefits represent a useless burden and foolish costs for sponsor companies and future beneficiaries. Real economies of scale, simplicity in administration, fully portable social benefits, cost-free mobility of workers and consistent taxation formulas would be beneficial for both the EU internal market and the European social model.

Indeed, the Alliance strongly believes that the economic and social objectives in the EU are not – and should not be - in conflict, but rather go hand-in-hand, and can be beneficial to each other: a “social market economy” is clearly mentioned in the Treaty of the European Union. In addition, the idea here is not to harmonise the (amounts of) social benefits in Europe: differences in wages or in the size of social security systems are still too big among the EU member states. The goal here is to get EU frameworks allowing cross-border benefits plans to work smoothly over the EU, by leaving the necessary freedom to the plan promoters to adapt their features on a national basis. In other words, harmonisation will be only requested when it will be necessary to overcome the aforementioned barriers, and in so far as cross-border benefits will be not achievable otherwise. For the rest, adaptations and adjustments to the different local situations will be a key feature of the new, envisaged cross-border plans design. It would be fantastic to imagine the EU as a big, open economic and social corridor where companies and workers can freely operate across the borders without any obstacles.

CBBA-Europe is not only important, but it is even more necessary in this very moment: as you know, the European Union is taking important initiatives in the pension field in order to promote pan-European solutions. The European Commission recently published its proposal for the PEPP (pan European personal pension), and the European Insurance and Occupational Pensions Authority (EIOPA) launched a consultation on the creation of a EU framework for a pan-European DC occupational pension (PEOP). Now more than ever, political discussions will arise on those initiatives. CBBA-Europe will do its best to support such initiatives, and to make them the most attractive for sponsor companies, workers and pension providers willing to offer cross-border pensions.

A strong development of pan cross-border solutions might allow offering occupational/workplace pensions in those EU member states where such pensions do not even exist.

In addition, capital accumulated by these pan-European funds could potentially be invested in the European economy, and contribute to the completion of the Capital Markets Union (CMU). That's why it is so important to develop cross-border social benefits schemes.

I allow myself to add that even Britain should be included in this huge space despite Brexit. If UK employers or social protection providers (i.e. pension funds or insurance companies) were interested in finding solutions for their employees or members across Europe before the finalisation of the exit from the EU, CBBA would be glad to support them.

With regards to the current EU initiatives in the pension field, there are some who argue that there is no appetite for cross-border pension/social benefits. What would you respond?

You are perfectly right. I find this statement quite funny, if I may say. Arguments like "there is no need" or "no appetite" for these schemes are often used by those who are strongly against smooth and cheap cross-border solutions in Europe.

In our opinion, these opponents of EU solutions for cross-border benefits such as the ones mentioned above (PEPP, PEOP) are afraid of them, because they know that the market would likely go for these solutions, undermining their domestic/local interests. In other words, the opponents of these initiatives defend the current fragmentation and status quo because they are afraid that the employee benefit plans (i.e. pension schemes) managed locally by national operators will move to other countries; or that providers based abroad will directly offer their solutions in those states, breaking up the local (high) costs, and the comfortable situation of limited local competition.

CBBA-Europe was precisely created to represent a voice in contrast to these opponents, by proving that the so called "market", or civil society (including several trade unions) do want cross-border solutions, especially in case of companies and sectors experiencing a big mobility of workers throughout the EU.

But once again: an optimisation of administrative fees deriving from wider competition and larger economies of scale should not undermine the social rights offered to workers in some member states. No-one here is advocating a "race to the bottom" of social rights of workers. On the contrary, the reduction of administrative burdens and management fees would better permit providing the same, or even better benefits at cheaper prices and easier conditions, and to finally offer benefits in countries where workplace benefits are not offered at all.

When is the official launch?

The official launch will take place on 6 December in Brussels. It will be a one day conference and we are honoured to confirm that the Chairman of the European Insurance Occupational Pensions Authority (EIOPA), Gabriel Bernardino, has confirmed his participation as keynote speaker. We will also have a high level speaker from the US, Phyllis Borzi, former Obama Administration's Assistant Secretary for Employee Benefits Security of the US Department of Labor. Other speakers will include officials of the EU institutions and agencies; representatives of multinational companies; trade unions; social protection providers that have already created, or are willing to create, Pan-European/cross-border solutions (also at multi-employer/sector-wide level). Delegates can attend for free.

What next for the Alliance?

From here-on, we hope that more individuals and organisations will join CBBA-Europe. We are currently appointing key positions within specific internal working groups and committees within the Alliance. The membership fee is rather symbolic: anyone can afford to join CBBA-Europe and the more members that join, the more influential our voice will be towards the EU. ■

If you are interested in joining the Alliance or attending the conference, please email: info@cbba-europe.eu or visit the website at: www.cbba-europe.eu

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ESG focus:

THE GROWTH OF SRI

Responsible investment

Ophélie Mortier explains the importance of integrating all three elements of ESG into investment processes

PAGE 28

Taking on the task

Elisabeth Jeffries considers the impact the Task Force on Climate-Related Financial Disclosure initiative could have on ESG investors

PAGE 30

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INVESTMENT

Responsible Investment: From niche to mainstream

Ophélie Mortier **explains the importance of integrating all three elements of ESG (environmental, social and governance) into investment processes**

WRITTEN BY OPHÉLIE MORTIER, RESPONSIBLE INVESTMENT STRATEGIST

Responsible or sustainable investment continues to grow significantly. The integration of ESG (environmental, social, governance) criteria into investment processes is definitely going mainstream. We consider this an integral part of our fiduciary duty as stewards of our clients' funds.

An increasing number of asset managers, including DPAM, are convinced that integrating ESG criteria is not an option, but a must these days. After all, it is not only about optimising the risk-reward of a portfolio, but also about excluding or mitigating certain risks. To name but a few, extreme natural events, large-scale forced immigration due to climate change, data protection and security, terrorist attacks…

These challenges reinforce our convictions about responsible investment being more than just a fad, and that we should integrate all three dimensions (E, S and G) into investment processes.

E = Environment

An economic challenge

The United States has pulled out of the Paris agreement because it sees it as a millstone around the neck of economic growth and full employment. However, its gross domestic product is set to decline by an estimated 1.2 per cent for every additional 1°C temperature rise. Under the Obama administration, the Pentagon had stated that climate change posed a risk to national security. Indeed, many Americans live near the coasts and a massive exodus to the centre of the country would have major consequences on social cohesion and the US economy.

The same problem crops up on a global scale. According to estimates by the International Organization for Migration, 20 million people were displaced and became refugees as a result of climate change in 2016. By 2050 this figure will rise to 250 million, presenting a major challenge to the countries accommodating the immigrants.

Industries that have been particularly hard hit:
Economically speaking, sectors like energy and transportation bear the brunt of this major challenge. Between 2015 and 2016, investments made in the oil and gas sector dropped by 26 per cent, amounting to nearly $650 billion.

Conventional electricity generation (gas, coal and nuclear) in Europe faces a major challenge due to global warming. Indeed, the water required to cool the power plants is becoming increasingly scarce. In 2030, it will need to reduce generation or stop it completely as there will be no fresh water available any more. There are solutions, but they entail significant investments to make cooling processes compatible with salt water. On the other hand, there are also solutions in alternatives to traditional capacity, namely in renewable energy. This sector currently employs nearly 9.8 million people worldwide. In the past four years, employment in the wind and solar energy industry has doubled. The new capacity, which has been installed across the globe, is growing by 10 per cent annually while production costs are constantly falling.

The transition challenge:
Energy transition is a major endeavour across the globe. It is creating many jobs and requires massive resources and financing, all of which could be profitable to multiple sectors and economies. It is also seriously disrupting the way we think about the construction of investment portfolios. In the past few years, we have been witnessing an industrial revolution. It requires a new way of looking at the analysis of the sectors in

question and selecting solution providers. In our international equity strategy, this is just one of the several secular themes we take into account, besides electric vehicles, batteries and storage, clean tech, hydro, etc.

S = Social

Demographics and the challenges of an ageing population:

We are on the cusp of a real demographic turning point. First of all, this is related to an ageing population, and not only on the Old Continent. Furthermore, by 2050 there will be 9.1 billion mouths to feed. This means that food security will be more important than ever. Finally, generations Y (born after 1980) and Z (born after 2000) have already outnumbered the baby boomers in the United States. They have significantly altered the attitude and consumption patterns of previous generations.

The agri-food sector in the line of fire

The agri-food sector, which is the largest water consumer and a major emitter of greenhouse gases, is directly impacted by the challenges resulting from demographic growth, climate change and food security. Investors have a role to play here, which goes beyond the fight against food speculation. On the contrary, they should opt for solutions which tackle the availability, accessibility and appropriateness of food and by investing upstream in the production chain (infrastructure, logistics, equipment, seeds, etc.) We should think about producing better instead of producing more.

Boasting a solid track record of over 10 years in this sector, we focus our research efforts on these innovative companies, in line with the sustainable development goals of the United Nations, including the eradication of hunger and the promotion of sustainable agriculture (objective 2) while protecting our oceans, seas and marine resources and using them in a sustainable way (objective 14) and by preserving and restoring terrestrial ecosystems (objective 15).

G = Governance

Ethics and placing governance at the heart of the investment process:

States, companies and civil society currently face a democratic paradox: while social networks, referendums etc seem to reinforce the democratic process, in reality it is fairly constrained. Sound governance, for countries as well as companies, is the cornerstone of any sustainable social and environmental policy. It ensures stability and results in lower volatility of investments.

Democracy: A work in progress

According to the latest publications by Freedom House and the Democracy Index, political participation is growing. At the same time, however, democracy is in continuous decline. Just 4.5 per cent of the global population now lives in a full democracy, compared to 8.9 per cent in 2015.

The United States, that beacon of civil rights and liberties, is now considered as a flawed democracy as confidence in the functioning of its public institutions is sagging. The faltering confidence in institutions and political elites on the part of citizens can also be seen in Europe. It requires us to remain focused and vigilant. The democratic foundations ensure other fundamental rights are upheld. They guarantee social stability and a more stable investment climate. This is a major criterion in our proprietary sustainability ranking of OECD and emerging market countries. For instance, in the emerging market universe, non-democratic countries are excluded.

A new business model:

The same applies for companies. On the one hand, the company Snap, which created the Snapchat app, has blatantly violated fundamental shareholder rights. On the other hand, major oil companies have succumbed to the pressure of their shareholders. From now on, they will disclose their environmental policies and risk management programmes related to climate change.

As a matter of fact, Snap, which is the holding company of the most widely used app among generation Z (between 0 and 18 years old) has angered its investors by scrapping all voting rights attached to its public shares, under the pretext of maintaining a dynamic and flexible business model.

Business ethics:

Here too, our world is changing completely, and companies can no longer operate the way they used to. Business ethics will become increasingly important. On the one hand, regulation is heading in that direction. On the other, civil society and investors are becoming increasingly aware of the issue as business ethics may influence shareholders and global inequality. Whether the corporate world likes it or not, ethics is becoming de rigueur. At Degroof Petercam, we have fully understood this challenge and for us, sustainability is part and parcel of our corporate values. ■

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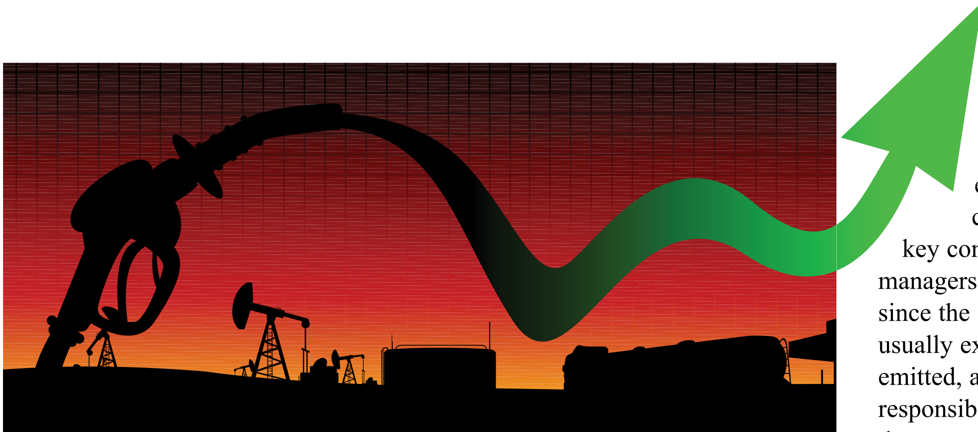


INVESTMENT

Taking on the task

Elisabeth Jeffries considers the impact the Task Force on Climate-Related Financial Disclosure initiative could have on ESG investors

WRITTEN BY ELISABETH JEFFRIES

Had Exxon Mobil reported its oil reserves differently in 2016, investors might have altered their view of the company's future. It stated that its Kearl oil sands were reserves, and in 2016 was ordered to debook them by the US Securities and Exchange Commission. Systematically considering climate-related risk would have resulted in a different disclosure, a practice that could transform the perceptions of ESG investors allocating funding within the hydrocarbons sector.

"If the company were to integrate climate risk into its assessments, it would highlight that these assets show a high propensity to become impaired. They would have been downgraded to a resource rather than a reserve, and this problem would have been foreseen", notes CDP senior analyst Tarek Soliman. The non-profit is among several organisations promoting the adoption of recommendations from a new high-level initiative, the Task Force on Climate-Related Financial Disclosure (TCFD). This venture was established by the Financial Standards Board, an international body that monitors and makes recommendations about the global financial system, and is chaired by Bank of England Governor Mark Carney.

If they declared their annual results according to the Task Force's recommendations published in July, oil majors might steer their businesses towards a less carbon-intensive pathway. Reporting financial activity through the lens of climate-related risk would, according to the TCFD, help more appropriately price risks and allocate capital in the context of climate change. The initiative is voluntary, would help speed the transition to a low-carbon economy, and helps shift the corporate perspective beyond immediate concerns.

Most companies are not reporting on this basis. Disclosures of historic greenhouse gas emissions by hydrocarbons companies, an industry of key concern for ESG asset managers, has certainly improved since the last decade. These figures, usually expressed in tonnes of CO_2 emitted, are often found in corporate responsibility statements. However, the pressure now exerted by the TCFD is to disclose for the first time in financial filings and to look far ahead into the future.

This is not about innovative accounting but more in-depth information. "It would change what the directors are telling us in the strategic report but wouldn't change [the structure of] the balance sheet and profit and loss account," explains TCFD special adviser and HSBC former chief accounting officer Russell Picot. For hydrocarbons, categories such as reserves and resources in strategic reports would be the numbers most likely to alter.

Leaders have already emerged, and the picture is mixed. In a 2016 study, *In the Pipeline*, CDP studied the hydrocarbon sector. It found Norwegian company Statoil the best hydrocarbons performer on carbon disclosure for the longer-term horizon, with Canadian company Suncor listed as the poorest, and Exxon Mobil last but one. "Statoil is the only company that quantifies what a world with a 2 degree Celsius [°C] temperature increase would do to its worth," says Soliman. Indeed, in its 2016 annual report, Statoil states that the International Energy Agency (IEA) '450 ppm scenario', compatible with that temperature increase, "could have a positive impact of approximately 6 per cent on Statoil's net present value compared to Statoil's internal planning assumptions as of December 2016."

Adopting TCFD recommendations

could increase the practice of carbon pricing in corporate reports - another way to express the risk of carbon regulation and to test the company's resilience in that light. Eight out of the 11 companies studied use an internal carbon price, ranging from USD 22/tonne to USD 57/tonne. Three (Chevron, Occidental and Petrobras) are silent on the matter.

According to Belgian asset management company DeGroof Petercam responsible investment strategist Ophelie Mortier, the Task Force provides "practical and concrete" assistance. Mortier considers that its recommendations to adopt carbon pricing to evaluate climate risk would make a significant difference to ESG investment research and decision making. But the inconsistences on carbon pricing need to be ironed out.

"Even though everyone agrees carbon is a risk, we don't have an agreed set carbon price per tonne. So I'm not sure everyone assessing investments can incorporate the carbon price, and do not know of analysts doing so," she says. As a result, some investment evaluations are not fully supported by appropriate information.

Mortier considers that scenario analysis, as advocated by the TCFD, would make an equally significant impact on DeGroof Petercam's work. The Task Force provides information on types of climate scenarios (produced by the IEA and others) alongside recommendations on the application of scenario analysis: a process for identifying and assessing a potential range of outcomes of future events (such as temperature increases of 2 degrees C) under conditions of uncertainty. From late 2017, the TCFD will also supply analytical tools and case studies to back up this activity.

Further help in this complex area would be quite useful, as Mortier suggests: "Scenario building is not at all easy to do," she says. "Only a few analysts have integrated this kind of scenario. They currently use Nationally Determined Contributions (NDCs) set following the UN Paris Agreement on climate change in 2015. But it's not easy to anticipate what countries a company will operate in," she observes.

A set of comparable sector scenario analysis would also assist investors. This could relate to a 2°C scenario as well as, for instance, scenarios related to NDCs and business-as-usual (greater than 2°C increase) scenarios. But the actual frameworks have yet to be shaped.

"We need to see a period of experimentation. Three or four years down the road we could potentially be assessing what is useful in the voluntary disclosures, and see it codified by institutions through, for example, stock exchange guidelines," says Picot.

Transition

The TCFD plays a significant role and comes at a time of transition. In the hydrocarbons industry, which makes a major impact on emissions, some oil and gas majors are considering climate risk, others are not. Some are acting accordingly, others paying lip service. One example of a directional shift is Italian company Eni, which is increasing the share of gas, a less polluting fuel, in its portfolio.

This industry differs from another carbon-intensive sector, the energy utilities, as Mortier points out. "For utilities, our sectoral analysis has seen a shift to low-carbon industries, and the shift has been integrated into utility investment. But our analysis shows oil and gas are a bit delayed on the shift to renewables", she says. Thus the TCFD data would provide major benefit for its investment teams, helping avoid investing in potential future stranded carbon-intensive assets.

If the corporate community systematically adopted the Task Force recommendations, balance sheet, income statements and strategic reports would need modifications. Picot points out: "Including climate risk would sharpen disclosures on the impairment of cashflows arising from assets."

But he suggested the most significant progression would be found in strategic discussions in financial statements. "This is not going to result in a huge data drop by companies but rather a thoughtful narrative description from board directors. It will hopefully be used as an engagement tool as well as a divestment tool," he says. A move towards less carbon-intensive business models could result. However, says Picot: "We're not saying they should alter their business model but that the information needs to get out there so that the market and the investment community can decide."

Disclosures on climate-related risk are improving but as the Statoil case demonstrates, the view of risk is always subjective. In 2015, Statoil assessed a 5 per cent loss in NPV, so the 6 per cent improvement estimated in 2016 demonstrated a u-turn in assumptions. Arguably, the risks to financial performance are considerable if a company moves away from its traditional business model or abandons its store of expertise. ESG investors will need to decide for themselves the extent of the climate risk to hydrocarbons companies. New data emerging as a result of the TCFD would mean they are better informed. ■

BREXIT

Crossing the border

As Brexit negotiations continue, the safety of cross-border pension contracts is being questioned and companies are facing some tough decisions. Lauren Weymouth **looks at how urgent the issue is and what can be done to make the transition easier for all**

WRITTEN BY LAUREN WEYMOUTH

On 23 June 2016, the UK voted to leave the European Union. While Brexit negotiations are still ongoing, the aftermath of the EU referendum is already being felt across the whole of Europe.

"This is an historic moment from which there can be no turning back," UK Prime Minister Theresa May said when the results were announced. "Britain is leaving the European Union. We are going to make our own decisions and our own laws. We are going to take control of the things that matter most to us."

But regardless of the positive or negative outcomes imminent when the UK fully exits the EU, there have already been some huge impacts on the financial industry. Since June, there has already been a spike in UK inflation as the pound lost value against other global currencies, and an increase in expected longer-term inflation.

This, Quantum Advisory senior consultant Simon Hubbard explains, "has caused greater uncertainty in financial markets, which has driven some investors to move into safer assets. The resulting fall in the yield available on UK gilts has added well over £100 billion to pension scheme liabilities."

And while the longer-term impact of Brexit is still going to depend on the UK's final negotiations with the EU, one of the most pressing issues among the pensions industry is the security of cross-border pensions at a time when the bridge between borders is about to come crumbling down.

Cross-border requirements

At present, cross-border pension schemes – those that have members in more than one EU state – are required to be fully funded under EU and UK legislation. This means, as a result of Brexit talks, sponsors of UK defined benefit schemes are now faced with two decisions: break the law or break promises to savers.

To put it simply, the main issue is that millions of insurance and pension contracts written prior to Brexit are still going to be in force post-Brexit. While this may not seem like a problem in itself, companies in the UK paying pensions to people living in the EU, including expats and anyone resident in the UK receiving a pension from the EU, are likely to be seriously affected.

Business insurance contracts, such as liability insurance sold from the UK to a company in the EU, as well as business insurance contracts sold from the EU into the UK, are all at risk too. Some insurers will lose their automatic license to insure in the customer's jurisdiction. They therefore may not be legally able to pay what they owe without a replacement agreement.

In response to a letter sent by Prudential Regulation Authority CEO Sam Woods to Treasury Select Committee chair Nicky Morgan, ABI director general Huw Evans said: "As the deadline for Brexit looms, many insurers' biggest fear is that they will be left with a stark choice between breaking their promise to customers or risk breaking the law if the issue of how to fulfil existing contracts cross-border is not resolved."

"Agreeing terms to allow insurers to service contracts after March 2019 needs to be part of the exit negotiations between the UK and EU," Evans said.

Safeguarding existing pensions

Fidelity head of international benefits consulting Mark Sullivan explains that the remaining EU states are "keen to take a slice of the UK financial services industry", and so there is pressure to remove EU financial product provision from the UK.

"It will therefore be a matter for negotiation to see whether the EU and the UK can agree to a continuation of cross-border provision of insurance and retirement solutions. As the UK Financial Services industry has been seen as the jewel in the crown by much of the EU this is likely to be one of the most difficult areas of negotiation," he adds.

However, Gowling WLG principal

associate Ian Chapman-Curry argues at this stage, "it seems as though the UK and the EU are having difficulty agreeing even the most important and headline of issues," let alone terms involving pensions and insurance contracts. "It seems unlikely the UK and the EU will get to this level of detail as part of the exit negotiations in advance of March 2019," he adds.

Although no final agreements have yet been made, other solutions are being put in place to offer savers across the union better options when saving for retirement. In June this year, the European Commission revealed plans for a Pan-European Pension Product (PEPP) – one of the key measures in the mid-term review of the Capital Market Union, a project that would create a single market for capital in the EU.

However, it is unclear whether the pension, which would be regulated by EIOPA, would be available to British savers after Brexit. Although both the EU and the British government have claimed they will protect the current pensions rights of EU nationals in the UK (and vice versa), there still hasn't been any confirmation to suggest whether the current arrangements would be made available to people who move between the UK and EU member states after March 2019.

A lifeboat

But it isn't all doom and gloom. According to Freshfields Bruckhaus Deringer, once the UK exits the EU, a scheme will no longer (by virtue of having members in the UK and the EU) be subject to cross-border funding requirements, which it claims represents "relaxation of the current cross-border funding regime".

The company adds that an exit from Europe also means the requirement to have the Pension Protection Fund (PPF) in place would no longer exist. "However, the creation of the PPF was largely the consequence of a political debate within the UK and resulting UK government policy, rather than being prompted by the imposition of European requirements.

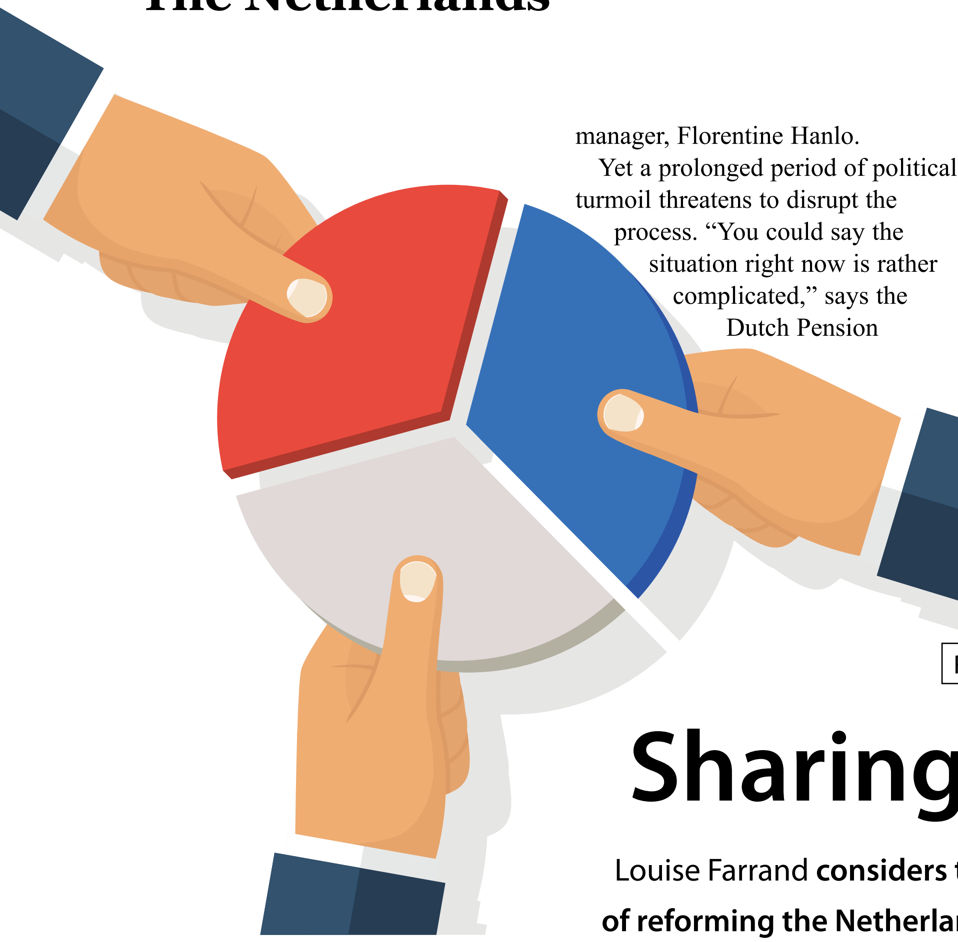
"Again, it would seem highly unlikely that there would be any political appetite to abolish the PPF or materially reduce the level of protection that it affords to occupational defined benefit pensions."

Director at Aries Insight, Ian Neale, argues that more pension schemes might be "liberated" to operate cross-border when the UK leaves the bloc. "Under EU law, the requirement to be fully funded at all times makes it very difficult for UK schemes to operate cross-border," he explains. "But the very few schemes based in the UK which do operate cross-border – mostly between the UK and the Republic of Ireland – might be adversely affected to the extent that they have to comply with two different future regimes, especially if these conflict."

Regardless of what happens over the coming years as Brexit negotiations continue, cross-border pensions and insurance contracts will inevitably remain and continue to be in demand. And although, as Evans warned, companies may well be left with a "stark choice" between breaking the law and breaking promises with customers, there still remains the chance there will be very little difference.

"For insurance and pension policies provided in the UK, they have historically had a very competitive pricing structure and medium and large employers have therefore adopted standalone UK plans rather than cross-border plans – so any impact will be limited," Neale says.

As Freshfields Bruckhaus Deringer concludes, this is because while much of the regulation of UK pension schemes is shaped by EU legislation "it is not dependent on it". ■



RISK

Sharing the load

Louise Farrand considers the proposals and challenges of reforming the Netherlands' pensions systems to fairly redistribute risk between all parties concerned

WRITTEN BY LOUISE FARRAND, A FREELANCE JOURNALIST

Like most European countries, the Netherlands is coming to terms with the necessity of reforming its pensions system. In the aftermath of the financial crisis, a prolonged period of low interest rates has threatened the sustainability of Dutch pensions. Public confidence in the system has also suffered.

Similar stories are heard across Europe. Where the Netherlands stands out is in its innovative approach to solving some of these common problems. Collectivism and compromise characterise the nation's culture, and pensions are no exception.

Accordingly, the Dutch are bravely forging a compromise route between defined benefit (DB) and defined contribution (DC). "The most significant trend in the Netherlands is that risk is moving from the employer to the employee," explains Kempen's senior fiduciary manager, Florentine Hanlo.

Yet a prolonged period of political turmoil threatens to disrupt the process. "You could say the situation right now is rather complicated," says the Dutch Pension Federation's director, Gerard Riemen. "We had elections in May this year and we still don't have a government."

Heightening the uncertainty is the fact that the different political parties take very different approaches to pensions. One party is in favour of a strictly individual pensions system, while another prefers the system to remain collective, explains Riemen.

In the absence of a government and political consensus, politicians are looking to trade unions and employer organisations to propose solutions. Everyone realises that reforms are inevitable. However, their exact nature is much more difficult to agree, says Riemen.

He summarises the crux of the concerns. "How can you get a better deal for the pensioners, and the people who are working right now, and for the future people who will enter the pensions system? That is a very difficult thing."

Join the collective

As Riemen emphasises, the current proposals could change significantly once the new government is in place. However, as they stand, members will shoulder investment risk in a DC-style accumulation phase, taking the onus off pension institutions and employers. Once workers retire, they will receive benefits, which will vary depending on economic conditions and life expectancy.

As SSGA's senior DC pensions strategist, Jacqueline Lommen, explains: "The new pension contract allows variable benefits in the payout phase of DC schemes. Financial and longevity risk will shift away from pension institutions and employers towards scheme members. In order to protect the scheme members, a – partially compulsory – innovative way of risk sharing is being developed."

"What we are trying to do is keep the collectivity and still share all the risk, but in the accrual phase not promise an accrued pension right," adds Bergamin Pensioenrechtadvies' (in association with Eversheds Sutherland) partner, Eric Bergamin. "Simply say, 'In the end there is an amount of money for you – it exists because you have premiums, investment profits, risk sharing and at the time you retire you can get an annuity. If you get this annuity, it still will be flexible depending on the profits on the investment, depending on longevity risk, inflation risk, et cetera'."

The current proposals also provide scope for retirees to alternatively opt for a retirement annuity income which would be unchanged, whatever the environment of the time. However, this would almost certainly be lower than the income they would receive in exchange for accepting some uncertainty.

There is no perfect solution, and the Dutch system has faced accusations of intergenerational unfairness in the past. It is all too easy for politicians to appease today's retirees with relatively generous benefits, at the expense of future generations who are not following the pensions debate as closely.

This issue is addressed under the new proposals, which state that if people live for longer than expected, they will face a collective cut in retirement benefits. Whether it's possible to set parameters for cuts in a worst-case scenario is "all part of the debate," says Riemen.

Another big question is whether to set aside a pot for emergencies, such as another financial crisis. As Riemen puts it: "Do you have a buffer, how much money do you put in it and when do you use the buffer to prevent a cut of the benefits? That's the intergenerational question."

While much is changing, some elements of the Dutch pension system will remain the same. Saving into a pension will remain mandatory, and investments will continue to be made collectively.

Lessons learned

"The Netherlands is doing what the rest of the world is doing: concluding that DB in its traditional form puts all the risk on the individual employer and we need to find ways of sharing risk. What marks the Netherlands out is its strong basis of strong partners and the collective fabric of society which means it is not going to do what the US, UK, Australia and Germany has done and move right to the other extreme," summarises Eversheds partner and head of pensions, Francois Barker.

As Barker observes, countries' approaches to addressing the same challenges have varied widely. In the UK, the-then pensions minister Steve Webb made headlines when he explored the idea of introducing collective DC in the UK. Since Webb lost his seat in 2015, the idea has lost its highest profile backer and much of its momentum – although UK master trust NEST did prove it was open to the idea in its much-discussed 2015 blueprint for retirement income.

Could we consider a Dutch-style approach in the UK? "I think that boat has sailed," says Barker. "However, there are many other lessons we could learn, around mixing elements of DB and DC. Why does it have to be all one and not a hybrid structure? There are all sorts of imaginative ways you could combine a DB and DC hybrid structure that would learn lessons from the Netherlands."

Making through-retirement investment more collective is another way that other countries – the UK included – could emulate the Dutch. Collective schemes have the luxury of longer-term time horizons, allowing them to access more illiquid asset classes, for instance.

This is an area where Kempen's director of fiduciary management, Wilse Graveland, feels the UK could potentially learn from Dutch pension funds. "My general feeling is there may be too many choices in DC platforms in the UK and that makes it very difficult in accumulation and decumulation to provide a collective. In the Netherlands, by changing the rules, it is all about how can you have a large collective when you have some choices but not too many because it gets very cost inefficient when only one per cent will take a particular option. Focus on which choices you want to provide."

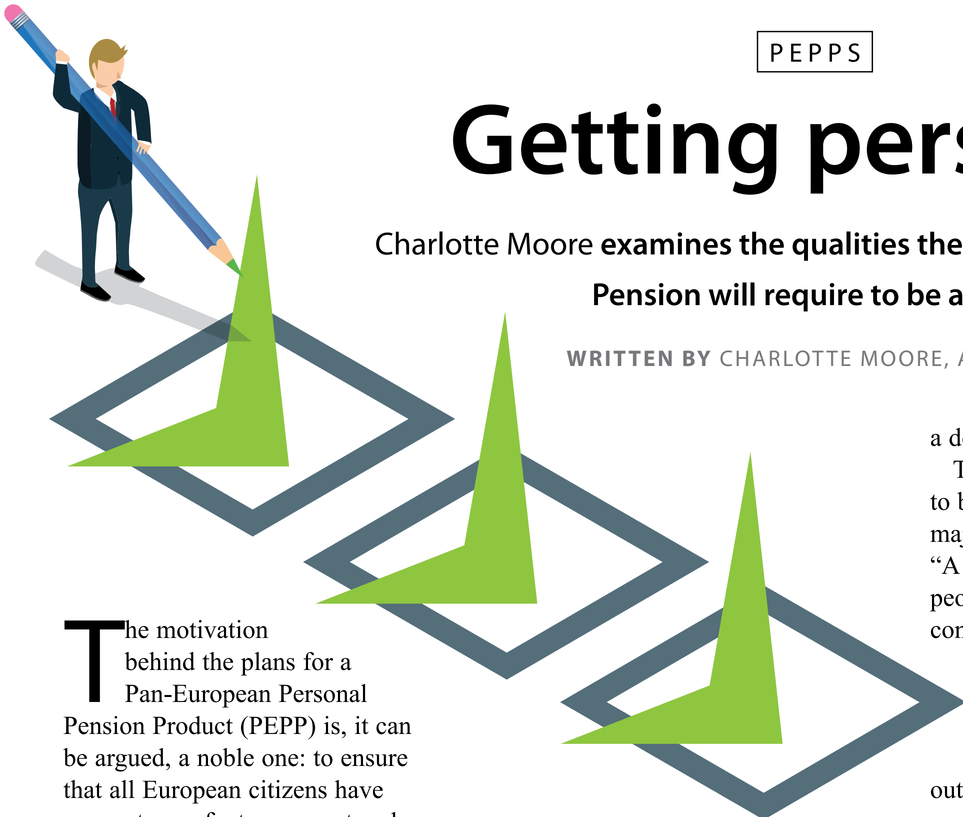
Lost in translation

In some ways, the Dutch system is unique, just like its history and culture. "Unlike the UK, where there is quite a lot of angst and antagonism between management and unions and to some extent companies and trustees … the idea that trustees of a pension scheme could bring down a company is completely anathema to the Dutch," says JLT director Charles Cowling.

He adds: "They would sit around a table and find a way forward that is fair to everybody. The Dutch way of doing things won't necessarily translate to other countries. It fits with the greater collective equality, sharing, society, rather than the 'me first' society that we have in the UK."

Riemen also urges caution when trying to learn lessons from the Dutch. "You have to see the whole picture when designing a pension scheme. We have mandatory pension schemes in the Netherlands. That is a huge difference. It is very important that you look to the whole picture instead of picking out certain features."

"That's one of the reasons why the unions are so hesitant to go along [with the current proposals]," adds Riemen. "They realise that if you take a step in one direction, there is no way back. It's almost impossible to go back to a DB system once you are in a DC system." ■



PEPPS

Getting personal

Charlotte Moore examines the qualities the Pan-European Personal Pension will require to be a success

WRITTEN BY CHARLOTTE MOORE, A FREELANCE JOURNALIST

The motivation behind the plans for a Pan-European Personal Pension Product (PEPP) is, it can be argued, a noble one: to ensure that all European citizens have access to a safe, transparent and cost-effective pension.

Demographic changes mean that nations cannot be over-reliant on state pension benefits and a stronger private pension system is required.

The European Insurance and Occupational Pension Authority (EIOPA) has been focusing its attention on a personal pension plan as this, it says, would appeal to a greater proportion of the population than a more traditional occupational plan.

EIOPA's leader of the pensions team, Sandra Hack, explains: "Developments in the labour markets make it more likely that people will be self-employed for at least part of their career and to have many more jobs than older generations."

Personal pension plans are also potentially a better option for those nations in central, eastern and south-eastern Europe that have nascent private pension systems. Hack says: "It makes sense to offer these personal pension plans to complement the creation of occupational pension systems in these countries."

Generating appeal

But it's not enough to just have a product that will be useful for the younger generation and does not require an occupational infrastructure – it also needs to inspire consumer confidence.

To achieve those aims, the PEPP aims to provide a product that is perceived to be safe, transparent and cost effective. These characteristics are particularly important if the PEPP is to appeal to people on lower income.

Hack says: "It's important to develop cost-efficient products to ensure charges are not higher than the returns generated by the product."

EIOPA is recommending various design features to this product to keep the costs down. Hack says: "Cost efficiencies can be achieved by making the most of economies of scale – this can be facilitated by a default investment option."

This default should be designed to be a 'safe' investment for the majority of the savers. Hack says: "A default also works because people find too much choice confusing."

But if a PEPP is to offer one default option, then it's important to design a strategy that will give the best outcome to as many people as possible. Hack says: "That means we have to have a vehicle that is not only focused on accumulation but also on creating significant retirement savings."

Proposed features for the PEPP include standardised limited investment choices – there would be one core default option where the link between accumulation and decumulation would be taken into account.

The European Commission has said that the PEPP should provide some protection, that as the minimum whatever has been paid into the product will be received back at retirement.

But while ensuring the PEPP provides a 'safe' investment choice and has some form of guarantee is appealing to consumers, there is a danger that such design features could impose too many constraints on the providers of these products.

Hack says: "It is important to find a balance between regulation that protects the consumer and ensures the providers are incentivised to work on good outcomes and innovative solutions."

Another issue is that the current economic environment is challenging for designers of investment products. Hack says: "Interest rates have been very low for a long period of time."

But this is an also an opportunity to find innovative solutions and the market should be allowed to develop these strategies.

Hack says: "We know that guarantees are costly but they have a value to the consumer." However, EIOPA does not think the default fund of a PEPP has to have a guarantee. Hack says: "Instead there could be an investment strategy that provides a protection mechanism."

One way to achieve these aims would be to protect consumers from downside risk while allowing them to participate in the upside gains.

Hack says: "We would like to transfer some of the lessons from the occupational pension sector to this product."

Profits

EIOPA has proposed that collective profit sharing products could allow a pooling of investments and smoothing of returns across members of the pool, allowing all members to benefit from average long-term returns of the fund and protecting them from extremely negative outcomes and stressed market conditions.

This could be similar to the mechanism now used by with-profits funds and collective defined contributions schemes.

Aegon pensions director Steven Cameron says: "The proposal does look like it is similar to the sorts of funds introduced in the UK a number of years ago to replace traditional with-profits."

The new generation with-profits funds offered a degree of smoothing of the unit values, protecting customers in periods of significant volatility. But to ensure that consumers have trust in this type of product, transparency is needed. Hack says: "The consumer would need to understand the profit sharing arrangement with other members and also the provider of the PEPP."

Profit-sharing arrangements need to be more closely aligned between different countries. Hack says: "There is huge variation in the allocation of profits between a UK with-profits fund, a French unit linked contract and a German life insurance contract."

IT'S IMPORTANT TO DEVELOP COST-EFFICIENT PRODUCTS TO ENSURE CHARGES ARE NOT HIGHER THAN THE RETURNS GENERATED

There could, however, be a conflict between the need to provide transparency and the mechanisms used to provide profit smoothing.

Cameron says: "New generation with-profits funds required careful management with detailed procedures to manage smoothing and ensure all customers were treated fairly."

For example, when market values are particularly high, the with-profits funds would hold back some profits which could be allocated to consumers when markets were at a lower level.

To implement this effectively requires complex and careful provisions in place to manage the pricing of the fund to not only keep the promises made to customers.

Willis Towers Watson senior consultant Mark Dowsey says: "The fund will be overseen by an actuary who will decide how much of the return can be allocated to members." This amount will be adjusted every year.

To achieve these aims, the fund provider would publish a unit price, which would often be very different to the actual value of the assets'. "That creates transparency issues for many consumers," says Cameron.

Dowsey says: "While it's possible to communicate clearly with the owners of a PEPP what level of profit they can hope to achieve in a year, there is no transparency over the underlying performance of the assets."

Implementing these types of measures also increases the costs associated with the fund. In the UK, for example, it would be impossible to provide the type of profit-smoothing within the charge cap imposed by the government on auto-enrolment funds.

Profit smoothing is not the only way, however, that large scale PEPP funds could achieve better outcomes for members. These funds could also create some innovation decumulation options.

For example, if the fund is large enough, it could create an internal market for more illiquid assets, like property. That would allow older members to sell these to younger members as they reached retirement. This would achieve a better price for these assets as they would not be affected by the impact of illiquidity on pricing.

Hack says: "There could also be greater flexibility for owners of a PEPP fund – they would not have to transfer all of their assets in bonds to match annuity pricing on retirement." They could, for example, keep part of their pot invested.

Hack says: "There is an opportunity with a PEPP to achieve broad economies of scale that will broaden the investment universe and improve cost efficiencies." ■

Insurance-linked securities:

A VALUABLE DIVERSIFIER

Investing in Insurance

Sidney Rostan sheds some light on the Insurance-linked securities (ILS) market

PAGE 40

An attractive niche

Sandra Haurant examines the case for pension funds looking to invest in ILS

PAGE 42

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SCOR Investment Partners

INVESTMENT

Investing in insurance

***European Pensions* speaks to Sidney Rostan, senior ILS portfolio manager, SCOR Investment Partners about the insurance-linked securities (ILS) market**

So what exactly are ILS and how popular are they with pension funds?

As financial instruments allowing insurers and reinsurers to transfer risk into the capital market ecosystem, insurance-linked securities (ILS) have become more and more familiar and popular with both insurers and institutional investors over the past decade. For insurers, they offer the capacity to de-risk and to diversify their sources of protection. For institutional investors, they offer diversifying yields, as the value of the asset is largely driven by the occurrence of natural catastrophe events that are not correlated to the financial markets.

How have ILS emerged?

Further to Hurricane Andrew, which made landfall in Florida in 1992 causing $15.5 billion in insured losses, the resulting shortage of reinsurance capacity prompted reinsurers, banks, and academics to investigate new ways of transferring catastrophe risks outside the traditional reinsurance capital pool. In 1997, USAA issued Residential Re, the first catastrophe bond to capital markets investors, protecting the insurance company against the risk of a major hurricane. Since then, approximately $91 billion of catastrophe bonds (cat bonds) have been issued, providing protection to insurers, reinsurers, governments, and corporations for a multitude of risks.

How is the ILS market growing?

Due to its undeniable diversification benefits and historically attractive risk-adjusted yields, the ILS asset class has expanded strongly during recent years. In terms of issuance volume, the market broke records in 2017 with $10 billion of cat bonds issued in the first semester (versus $7 billion for the full 2016 year). On the asset management side, the growth of assets under management benefitted an increasing number of investment managers.

However, this large inflow of liquidity is taking place in the context of a softening market in the reinsurance industry. Indeed, due to the lack of important disaster and losses over the past decade, the returns offered have continuously fallen year after year since 2012.

Would the recent events, such as hurricanes Harvey or Irma change the paradigm of ILS market?

The succession of two major hurricanes land-fall in the US in less than a two-weeks period time is a premier at least in the last 150 years. However, it is still too soon to determine if Hurricane Irma would be the test for the ILS market. Irma is a major hurricane that is going to be ranked among the costliest in the insurance, reinsurance industry and ILS industry. Investors in the ILS market may experience their largest loss in years. Volatility will also run high during the weeks following these events.

Eventually, the current period does remind investors that the asset class involves significant insurance risks in case of the occurrence of one or a succession of severe natural disasters.

Is there anything else investors should consider when looking at ILS?

Beyond the headlines, the two points investors should pay attention to are selectivity and consistency. In all markets benefiting from large new sources of capital, the temptation for issuers to propose more aggressive structures is high. ILS does not derogate to the rule. Over the past few months, the market has proposed top and drop or cascade structures, while some deal with no franchise, for example. Such structures imply more risk for investors, therefore in the current market conditions selectivity is key in order to limit bad surprises in the future.

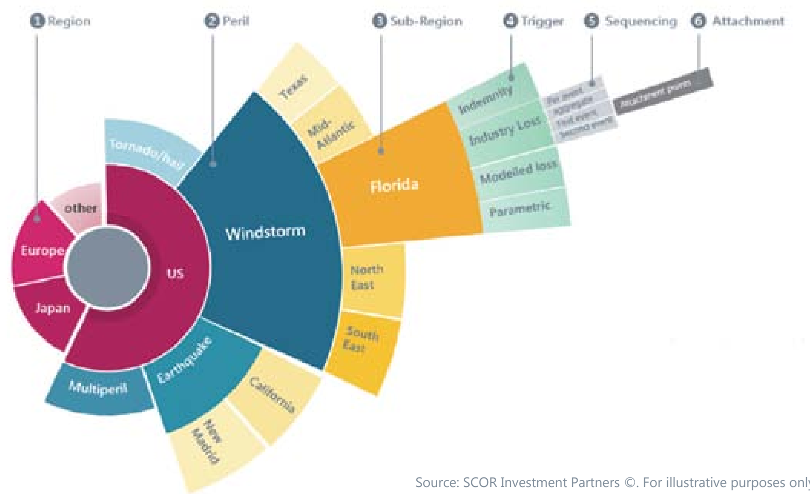
Consistency is the other side of the mirror. One may be tempted to deploy the new cash by diverging somehow from its initial investment strategy. This could be by either increasing the portfolio risk to maintain a high level of remuneration or by investing in new lines of business that support more model risk. And in the ILS market like any other, the voice of wisdom is often common sense.

For instance, take only the risks that one understands. In the ILS world the rule applies and the diversification of the portfolio must not be at the expense of risk control.

As a result, one may favour portfolios that are exposed only to natural catastrophes on which the market benefit from robust models based on long-term data.

But actually, it is interesting to note that most of the recent losses experienced on private ILS instruments are linked to non-natural catastrophes, such as the wreckage of the Costa Concordia, the Tianjin harbor chemical blast, or also the Jubilee oil field business interruption loss. The Jubilee FPSO event is an illustration of the expansion of the ILS market towards new lines of business, including marine and energy. It is also a good example of a complex man-made loss event: a failure of the turret of the floating oil production vessel in March 2016 led to multiple production shutdowns, increased production costs and long lasting repairs, which are still in progress and which triggered significant insurance claims.

Diversification and risk mutualisation: a multiple dimension approach



Source: SCOR Investment Partners ©. For illustrative purposes only

What are the options to enhance the diversification of a natural catastrophe (nat cat) portfolio?

An ILS portfolio with a significant focus on nat cat does not mean a less diversified portfolio. In fact, diversification can be achieved through the multiple dimension of the risks involved in an ILS contract.

In addition, to the obvious segmentation by peril/ region or peril/sub region, portfolio managers can enhance the diversification of the funds they propose by diversifying their exposure per type of trigger, type of event sequencing and by level of attachment. As a result, using these different layers of diversification allows a portfolio manager to hold various securities covering the same event while reducing its risk.

Two ILS instruments exposed to the same event won't necessarily behave the same way. For example, consider a portfolio manager exposed to a second event hurricane in Florida at a lower attachment point and to a first event hurricane in Florida at a much higher attachment point. With the occurrence of a severe hurricane in Florida, the first exposure won't be triggered, because it is the first event of the season, and the second exposure won't be affected either because the attachment point is not reached.

Currently, the attachment point dimension is quite interesting for peak perils, showing the best risk-adjusted return levels of the market. The exposure to this type of perils through instruments with higher attachment points is a good way to combine yield and risk control.

When using the different levels of diversification at its disposal, a portfolio manager can achieve satisfying risk control while benefiting from the attractive yield of peril risks.

The range of ILS investment strategies proposed to pension funds is extremely wide. Before getting involved an investor should ask itself what level of liquidity he needs (weekly, monthly, annual?), what level of return is targeted and what level of risk/drawdown can be accepted.

As an illustration, we propose a blended strategy combining 2/3 of cat bonds and 1/3 of OTC that offers enhanced diversification with a monthly liquidity. This type of strategy has encountered significant success among investors looking for recurring yields and decorrelation.

Nevertheless it is important to highlight and repeat that the asset class involves significant insurance risks in case of the occurence of one or a succession of severe natural disasters. ■

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SCOR Investment Partners

INVESTMENT

An attractive niche

Sandra Haurant **examines the case for investing in insurance-linked securities**

WRITTEN BY SANDRA HAURANT, A FREELANCE JOURNALIST

Insurance-linked securities, or ILS, are essentially debt instruments that are generally used by insurance and reinsurance companies to transfer the risk of loss to the capital markets. There are a number of different types of ILS, but perhaps the most familiar is the catastrophe, or cat bond, which, as the name suggests, is used by the issuer to cover the risk of a catastrophe, for example an earthquake or a hurricane.

These securities pay a coupon to the investor during their lifespan, as long as none of the catastrophes they cover occurs. If an event covered by the bond does happen, and the issuer suffers losses, then the investor is likely to lose coupons and principal, depending on agreements in place.

ILS as an asset class fits firmly into the alternative sphere, and this was once considered an extremely niche area of investment. Indeed, its reach remains relatively small-scale in terms of assets under management. According to the Willis Towers Watson Global Alternatives Survey 2017, pension fund assets managed by the top 100 alternative asset managers in the sector amounted to $1,611 billion in 2016, of which around $9.4 billion was allocated to ILS, making it the smallest asset class, coming in just after natural resources. Of the other alternatives, real estate was most popular, followed by private equity funds of funds, direct hedge funds, infrastructure funds, illiquid credit, direct private equity funds and funds of hedge funds.

Growing interest

It may be starting from a small base, but interest is growing, with some sources claiming that the number of pension funds with an allocation to ILS and other reinsurance linked assets has doubled from 1 per cent to 2 per cent. In some countries, ILS has been attracting attention for some time. The Netherlands and Nordic countries, often frontrunners with burgeoning areas of investment, have been enthusiastic, but perhaps the earliest adopter in this area was Switzerland.

"Pension funds in Switzerland have known about and been invested in ILS for a very long time, some since the middle of the 2000s," explains Scor Investment Partners head of ILS Vincent Prabis. "One of the reasons is proximity. Some of the first funds dedicated to ILS were launched in Zurich. Most of the insurance and reinsurance industry is based around Zurich, and because of long historical ties between pension funds and the insurance and reinsurance industry, there was a pretty quick take-up rate and a clear understanding of what ILS was setting out to do."

It's not just a question of geography though; another key driver in Switzerland is arguably a long run of low interest rates, currently standing in the negatives at -0.75%. Willis Towers Watson head of advisory portfolio management Alasdair MacDonald says: "The search for yield began more recently in the UK and Europe, but in Switzerland it has been ongoing for a long time and very limited government bond issuance, and insurance-linked securities do look like a slightly higher yielding bond."

Low yields elsewhere are certainly a driver for this area of investment, agrees Prabis. "The number one is definitely the low-yield environment. Interest rates have been low for quite a while, and while there seems to be a form of consensus that sooner or later they will rise, it will be later than was anticipated a few years ago and, slower than was anticipated even recently," he says.

"That low yield environment forces pension funds to look at places where they didn't look before. They are reviewing and allocating to other asset classes, particularly on the alternative side, which seems to be the only place where they are able to find some value and some much needed yield."

Lack of correlation

Another draw is ILS's lack of correlation with other asset classes, which makes a very strong case for ILS as a diversification element in a portfolio, adds Scor Investment Partners ILS portfolio manager Sidney Rostan. "It is very attractive because of decorrelation and diversification," says Rostan. "This asset class has proven to be decorrelated from almost all the asset classes, including the mainstream ones, but also other alternative asset classes, through the crisis and also more recently at the beginning of 2016, these assets hadn't been affected at all by overall market turmoil."

Solvency II, the EU-wide harmonised regulatory regime essentially designed to make certain insurance companies have the required capital to meet their obligations, has also helped raised the profile of the ILS. "One question that is raised by potential investors, who understand very well what we are doing, is: 'Why do you have access to this risk? Why don't insurance and reinsurance companies that worked together for hundreds of years keep it to themselves?'" says Prabis. "There are a number of reasons why reinsurance and traditional insurance companies need ILS now to cover their own needs, but one of them is Solvency II."

Managing risk

Of course, ILS, including cat bonds, are not invulnerable. By their very nature, they can literally be shaken to their core in the event of an earthquake, or, as we have seen recently, blown off course by a hurricane. Hurricane Harvey left a trail of destruction across Texas and Louisiana, bringing with it tragic loss of life and environmental devastation.

The economic impact of the disaster will take time to calculate, and at the time of writing estimates covered an enormous range, and reached as high as $190 billion. In 2005, Hurricane Katrina cost around $160 billion. Just how these losses will affect the insurance, reinsurance and ILS markets is not yet clear, explains AXA Investment Managers head of ILS Francois Divet.

"Economic losses are not [likely to be] so relevant for insurers and reinsurers and ILS managers, because in the ILS space, as with traditional insurance and reinsurance, we only cover the losses that are covered through an insurance policy," he says.

When it comes to insurance for these kinds of events, wind damage is usually the key element that is covered, and, says Divet: "Most of the costs [here] are not coming from the wind when the hurricane made landfall, they are mainly coming from flooding, and in the insurance market the flood policy is not mandatory, meaning that you have a limited number of personal individuals purchasing this insurance policy for flooding."

Losses with ILS are generally triggered by the losses reaching a certain threshold – and even if the losses caused by Harvey do not reach that level, subsequent hurricanes might reach the limit on an aggregate basis. "Because of these mechanisms, even if the cat bonds are not triggered by an event such as Harvey, they may suffer mark to market decrease because the probability of the trigger in the next event is higher," says Divet.

Meanwhile, losses caused by events such as these may lead to a rise in premiums, and this, says MacDonald, often leads to an increased interest in the ILS market. Recently, he says: "Premium rates have fallen to low levels, so it has reached a point where you are not getting very well compensated for the risks you are taking. Harvey may change that significantly, although we can't yet say what the impact has been."

ILS remain a niche asset class, and although they are becoming better known, there is still a long way to go before they are anywhere near mainstream. "Understanding ILS is definitely a hurdle," says MacDonald, but then, he argues, there are also other areas competing to provide an answer to the yield question – citing property and less liquid credit markets as potentially more attractive options.

The future for ILS, then, is unclear. But one thing is for certain, its ability to buck market trends will continue to make this asset class something of a one-of-a-kind in the investment world, says MacDonald: "The one thing you can't take away from ILS is that it is the only genuine guaranteed-to-diversify asset class on the planet, because hurricanes don't cause equity crashes, and equity crashes don't cause hurricanes or earthquakes." ■

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INVESTMENT

Rooms to spare

Norwegian Government Pension Fund Global has acquired a number of stakes in property over the past few months. ***European Pensions*** **looks at the reason for this and what property can offer European pension funds in today's market**

WRITTEN BY PETER CARVILL, A FREELANCE JOURNALIST

Investment in real estate by funds, particularly Norwegian funds, has gathered pace. In May, it was reported that Norges Bank Real Estate Management, acting on behalf of the Norwegian Government Pension Fund Global, had bought three properties in London in a deal in partnership with The Crown Estate. This was followed by similar deals in July where the same fund purchased a stake in property in Washington DC, and the purchase of an office building in Berlin. Hot on the heels of those was a property purchase in central Paris.

Building interest

These developments are not storms in a teacup, but reflect a larger shift in how funds operate. Data from Preqin shows that in 2012, the number of active European pension fund investors in real estate stood at 203, with an average allocation of 10.4 per cent. By 2017, that had grown by 22 per cent to 248 investors, and average allocations of 12.2 per cent. The same trend is replicated across the globe: in 2012, the number of active pension fund investors around the world stood at 650, with an average allocation of 8.2 per cent; five years later, that first figure had increased 27.5 per cent to 829, with average allocations of 10 per cent. The data also shows that 87 per cent of all public and 73 per cent of all private sector pension funds currently invest in real estate.

The writing may have been on the wall for some time – in 2013, Jones Lang LaSalle predicted that direct investment in real estate by pension funds and sovereign wealth funds would double over the following decade.

There are specific reasons for this. One argument posited by J.P. Morgan in 2013 as a reason for funds to invest in real estate was that assets such as property provided 'all-weather' protection for pension funds, delivering better returns in high-growth environments than bonds, while being more defensive than equities in periods of lower-growth.

Another reason is that real estate provides a stable income stream over the longer term, allowing funds to closely match their liabilities. Diversification is also key, as is lowering risk and providing a hedge against inflation. As interest rates remain low, investors have looked towards asset classes like these because they currently outperform equities and fixed income products.

However, investment has not been uniform: allocations by public pension funds in this sector are more than double those of the private sector – $681 billion to $340 billion.

The reason for this, says Jones Lang LaSalle's head of capital markets Matthews Richards, is that the former tend to be larger than their counterparts and require more diversification.

"For some of the smaller company pension funds with a smaller volume of capital available to deploy," he adds, "it makes more sense for them to invest indirectly via private real

estate funds or the equity market, rather than purchasing real estate directly, which requires active asset management."

Investment approaches

The size of a fund's AUM also by-and-large influences real estate investment. Only 13 per cent of public funds with less than $1 billion AUM invest directly in real estate; among those with AUMs over $50 billion, that figure increases to 66 per cent. "This happens," says Preqin head of real estate product Oliver Senchal "because public sector pension funds have been in this space for a longer time. Indeed, 87 per cent of them have investments here and they've been doing it for much longer than private sector funds so they're more."

A lack of direct investment, however, does not correlate to a lack of overall investment; smaller pension funds, says Richards, may not have the 'critical mass' available to deploy in direct real estate investment. They might, he says, explore other avenues such as investing in REITS or private real estate funds. "For example, a small pension fund with $1 billion AUM with a typical 4 per cent allocation to real estate can only deploy $40 million to real estate, which would not even buy you one prime office building in London. Hence, economies of scale apply: as the size of the pension fund increases, the more capital and expertise there is at hand to invest in direct real estate to achieve the required diversification."

Such wide investment in property has knock-on effects, though. The city of Berlin has seen rent prices skyrocket in recent years as a result of intense property investment – often by pension funds – in the city. The so-called 'Berlin lifestyle' of cafes, cheap rents, and cultural cache has drawn investors and residents from around the world. At one point, the city was, according to Schroders, '[…] rated the number one investment market by ULI and PwC'. The result was an increase in rents of 70 per cent between 2004 and 2016. From this has come tensions in areas such as Prenzlauer Berg, Kreuzberg, and Neukölln, that have been transformed by gentrification.

"The pension funds that we speak to," says Richards, "are frontrunners in ESG investing, and this also applies to their investments into real estate. Both private and institutional investment can offer a number of important benefits and advantages to cities pursuing long-term goals, including supplying critical capital in areas which are traditionally under-funded by the public sector, such as infrastructure, and adding diverse perspectives, ideas and solutions to city development."

However, Willis Towers Watson's senior investment consultant, Douglas Crawshaw, maintains that there are limits that funds can go to in this respect. "At the end of the day," he says, "they have a fiduciary duty to their members. They are there to provide pensions when those members retire. That's their purpose."

Recent research indicates that 64 per cent of funds believe it harder to find attractive opportunities in real estate than it was a year ago, and a little over two-thirds think asset prices to be a key industry concern. A tightening of supply is driving prices higher, too, and reducing the cost-benefit of investing in real estate. "Nonetheless," say Preqin, "real estate remains a crucial part of many pension fund portfolios, with investments in the asset class able to mitigate against fluctuations in traditional bond and stock markets."

Moving out

Senchal acknowledges that current trends have shown it to be harder to find attractive, viable real estate within Europe. "Fund managers are looking at different markets and regions. Where once they may have gone for core properties, they may now go for core-plus properties. A core property is an asset that has strong tenants in a prime location, making a consistent income stream. A core-plus property means it might need some renovations and improvements in order to bring it up."

Richards says that long-term investors may seek to target secondary cities or emerging markets in order to achieve higher yields. "The key success factor for these markets to attract pension fund investment is transparency and liquidity.

"For example, improving transparency in Central Eastern Europe had led to Asian investors such as Korea's NPS investing in a Prague office building together with LaSalle Investment Management."

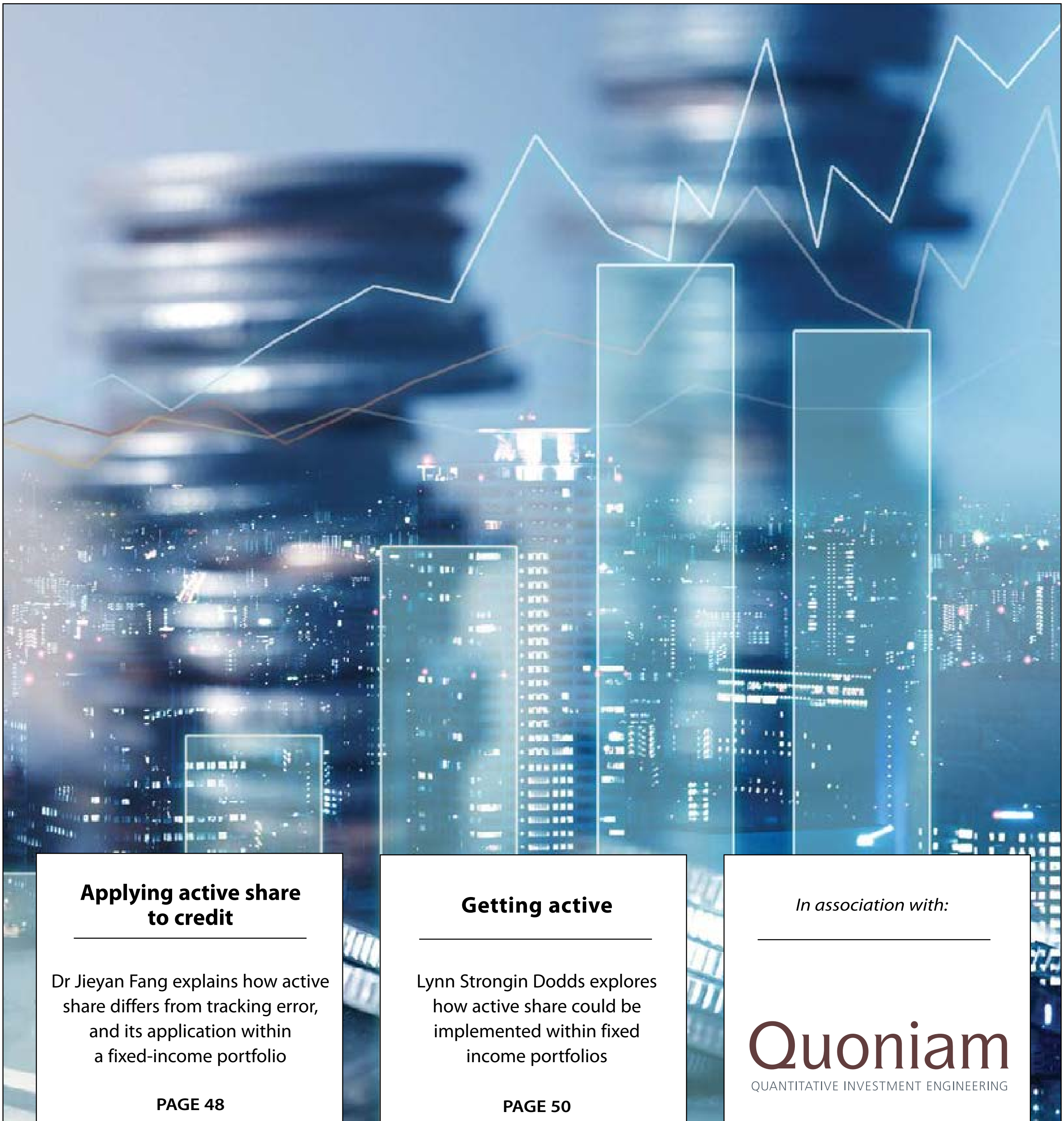
He adds: "There is, however, still plenty of potential supply in real estate which doesn't trade often yet, such as buildings owned by corporates and governments."

The risk when talking about European property is in treating each country as if they are all the same. They are not. Recent, heavy investment in infrastructure in Poland and Czechia has made those countries attractive options with competitive pricing. Other countries, such as the UK, may be heading for more-turbulent waters.

Crawshaw says: "I think continental Europe is a few years behind the UK in terms of cycle and you could argue that there's still some upswing to go on the continent. It's not gone in the UK but we could be at a later point. And if the UK is perceived as riskier because of Brexit, they may encourage investors to switch and become more focused on the EU." ■

Active share focus:

SHEDDING SOME LIGHT



Applying active share to credit

Dr Jieyan Fang explains how active share differs from tracking error, and its application within a fixed-income portfolio

PAGE 48

Getting active

Lynn Strongin Dodds explores how active share could be implemented within fixed income portfolios

PAGE 50

INTERVIEW

Applying active share to credit

Quoniam Asset Management GmbH senior analyst, fixed income research, Dr Jieyan Fang

Dr Jieyan Fang talks to *European Pensions* about how Active Share differs from Tracking Error, and its application within a fixed-income portfolio

Different Types of Active Portfolio Management

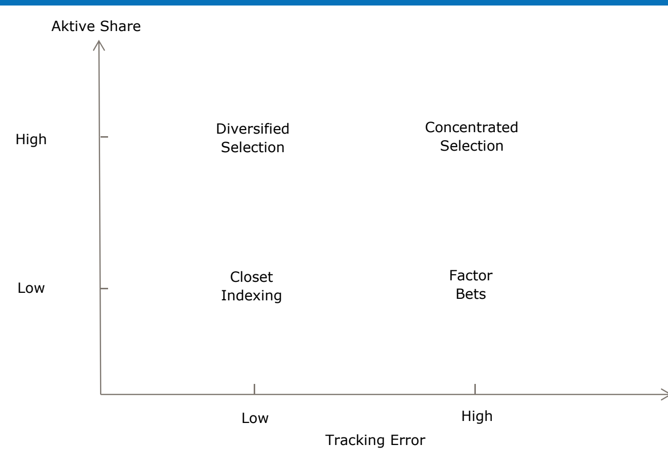


Figure 1, Source: Cremers and Petajisto (2009)

Please can you explain exactly what Active Share is and how it is used within an investment portfolio?

Active share was introduced by Cremers/Petajisto (2009). It is a holding based measure. This means Active Share is used to calculate the percentage of the fund's holding that differs from the benchmark holding. The Active Share of a portfolio usually varies between 100 per cent – in case that all portfolio holdings are not included within the benchmark – and 0 per cent – in case that portfolio and benchmark are composed of exactly the same holdings. In particular circumstances, where for example leverage and short positions are included, the Active Share of a portfolio can even exceed 100 per cent.

What is the difference between Active Share and Tracking Error?

Tracking Error is a common measure looking at the 'activeness of portfolios'. This is defined as the standard deviation of the differences in returns between the investment portfolio and its benchmark. Both measures may at first glance seem similar, but due to the different definitions, Tracking Error and Active Share actually capture different aspects of the activeness of the portfolio.

As mentioned above Tracking Error is calculated by using portfolio and benchmark returns. It considers the covariance between the returns of the portfolio and the benchmark. Therefore, Tracking Error is strongly influenced by factor exposures and can therefore be used as a proxy for factor bets.

In contrast Active Share is calculated by using portfolio and benchmark holdings. Each position is treated equally. It measures the holding difference between a portfolio and its benchmark. Therefore, Active Share is a proxy for the level of active security or issuer selection.

Where is Active Share typically used within an investment portfolio? For example, is it used within equities or fixed income asset classes?

Since Active Share was introduced by Cremers/Petajisto (2009), it is typically applied to equity portfolios both in the fund industry and academic research. For fixed income the measure is gradually becoming more important.

Is it possible to apply Active Share to credit portfolios?

Yes, it is possible to apply Active Share to credit portfolios. The measure provides information about the activeness of the portfolio regarding the issuer selection.

What should pension fund investors pay attention to if applying Active Share to credit portfolios?

There is a special feature that should be considered when applying Active Share to credit portfolios. Typically, a company issues different bonds with different characteristics. This leads to the difference between Active Share at bond level and at issuer level. Active Share at issuer level is generally lower than at bond level, because bonds from one issuer are considered to be equal and the overweight of a certain bond from one issuer in the portfolio does not necessarily lead to an increase of Active Share.

Active Share at bond level treats each bond individually and considers differences in its characteristics. Both forms provide useful information about the activeness of the portfolio.

How can you identify different asset managers using Active Share and Tracking Error?

This can be achieved by applying the methodology of Cremers/ Petajisto (2009) and classifying four different types of active management, as shown in figure 1.

Funds with low Tracking Error and high Active Share are defined as Diversified Selection, focusing on selection instead of factor bets.

Portfolios of the type Concentrated Selection apply both, selection and factor bets. Therefore, we can observe high Active Share and high Tracking Error in this segment.

Factor Bets portfolios show high Tracking Error and low Active Share. These kind of funds do not deal with selection but bet on certain systematic factors.

Closet Indexing funds do not engage in selection and factor bets. Therefore, they have low Active Share and low Tracking Error.

How is the cutoff point for Active Share defined?

Cremers/Petajisto (2009) defined the empirical cut-off point for Active Share of equity portfolios as 60 per cent.

Considering the specific characters of credit portfolios and credit benchmarks, it is more difficult for credit portfolios to achieve a high Active Share compared to equity portfolios.

Nevertheless, the funds we manage here at Quoniam have the cut-off point of Active Share at 60 per cent. The cut-off point of the annualised Tracking Error is defined as 1.5 per cent, based on an empirical analysis of the peer group funds (Morningstar Category: EUR Corporate Bond).

Finally, to put this information into context, please could you provide an example of the application of Active Share and Tracking Error?

In order to illustrate the application of Active Share and Tracking Error, I use one of the mutual funds managed by Quoniam: Quoniam Funds Selection SICAV – Euro Credit EUR I.

The results are shown in figure 2. The Active Share of this fund as of 31 March 2017 is 70 per cent at issuer level and 88 per cent at bond level, and thus is significantly higher than 60 per cent. Annualised Tracking Error is 0.8 per cent, which is just the 15th percentile of the peer funds.

Based on the definitions of the four types of active management, the Euro Credit EUR I belongs to the Diversified Selection, focusing on the selection of the Euro credit issuers/ bonds and shows high Active Share.

Factor bet on systematic risk factors eg duration, quality and sector, which drives the Tracking Error, is not a main strategy of this fund.

This example illustrates the importance of Active Share, which mainly captures the selection aspect of active management, while Tracking Error indicates factor bets. Even though substantial Active Share is no guarantee for outperformance, the before mentioned fund outperformed the benchmark by +1.2 per cent p.a over the last five years with a Tracking Error of only 0.8 per cent. Nevertheless significant Active Share is an indispensable precondition for outperformance through active bond or issuer selection.

The standalone application of Tracking Error might provide false information about the activeness of credit portfolios. The combination of both measures provides a more complete picture of activeness of credit portfolio. ■

Active Share and Tracking Error of Quoniam Euro Credit EUR I (ISIN LU1120174880*)

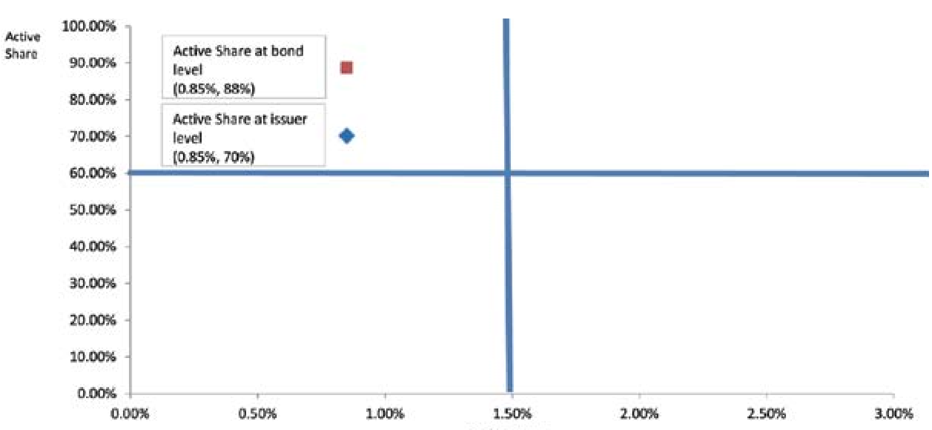


Figure 2, Source: Quoniam,
**Asset Manager: Quoniam Asset Management - Administrator: Union Investment Luxembourg S.A.*

INVESTMENT

Getting active

Lynn Strongin Dodds explores how active share could be implemented within fixed income portfolios

WRITTEN BY LYNN STRONGIN DODDS

Active share, which measures how much a fund's holdings deviate from its benchmark index, has gained a following in the equity space as regulators and investors bear down on active managers to prove their worth. However, it has been slow to catch on in the fixed income realm and views are split as to whether it would be a useful indicator of acumen.

The measure first came onto the scene in the wake of the financial crisis with the publication of a research paper in 2009 from Martijn Cremers from the University of Notre Dame and Antti Petajisto New York University (NYU). They found that equity funds with an active share of 80% or higher (ie, funds holding 80% or more stocks that were outside their benchmarks) beat their indexes on average by 2% to 2.71% before fees, and 1.49% to 1.59% after fees, per year.

Cremers and Petajisto showed that the best active fund managers not only had the highest active share, but also had clear and well defined systems for determining which stocks to buy. They stood out for their disciplined methods as well as their buy and hold commitment, even during periods of underperformance.

Fast forward to 2017 and a study conducted by Willis Tower Watson (WTW) revealed similar patterns. It found that 26% of the 977 global equity funds in the eVestment database were actively managed and the majority that outshone the benchmark pursued a so-called "high active share" investing style

One of the main reasons active share has usurped tracking error as a popular analytical tool is the mounting scrutiny from regulators such as the Financial Conduct Authority on the high fees active managers charge. "There was a recognition that tracking error only captured part of the story and that it was not a perfect measure of the activity of a portfolio which is why active share is being used for equities," says Quoniam Asset Management senior analyst, fixed income research, Dr Jieyan Fang. "Tracking error mainly indicates factor bets while active share reflects security selection."

Fang adds that while regulatory pressure has been one of the main drivers behind the popularity of active share, investors have also demanded greater transparency to ensure they are getting value for their money from active managers.

Candriam Investors Group deputy CIO Koen van de Maele though believes that while the metric can add information in equity portfolios, it is mostly misleading if only used in isolation and should be used in combination with tracking error. This is because it doesn't give a sufficiently broad picture of a portfolio.

"Active share doesn't show how different the securities are from the securities in the benchmark," he says. "For example, a telecom stock in the benchmark can be replaced by a similar telecom company, or alternatively something very different as a gold mining stock. In both cases, the active share might be the same.

Fixed income

Van de Maele believes the challenges are even greater if applied to fixed income. "Active share in equity portfolios can be useful despite its shortcomings but I would ignore the measure of most bond portfolios," he says.

"There are three main dimensions – interest rate, credit and currency risk - and they have always been the main indicators to assess the active risk of fixed income against a benchmark. Also, active share in bond portfolios is difficult to interpret since large companies and countries tend to issue dozens of bonds. No one will buy all these bonds, even if the risk against the benchmark is supposed to remain low. This means that even with a relatively high active share, a bond portfolio can still behave similarly to the benchmark."

WTW senior investment consultant Kate Hollis echoes these sentiments. "Fixed income is multi-dimensional in that you can be matched to a benchmark by percentage allocation to issuer but that does not mean you are matched by duration and currency," she says. "Also, asset managers who invest in bonds use derivatives much more significantly than equity managers which create complexity. For example, if you are buying S&P futures you can sell the index, but if you are using iTraxx to hedge credit there is no relation to the benchmark in terms of issuer exposure."

Not surprisingly, the complicated nature of fixed income also makes it difficult to apply a standard calculation, according to Morningstar associate director, fixed income strategies, manager research, Mara Dobrescu. “However, there are subsets such as European high yield or corporate investment grade where active share is easier to calculate because the universe of bonds is much smaller than, for example, global bonds, which is highly diversified with different issuers and maturities.”

Fund managers such as MFS Investments are already exploring the potential of using active share in high-yield portfolios. The credit focus and the larger degree of idiosyncratic security-specific risk compared with most other fixed income strategies, suggests that active share may be a particularly relevant risk measure for these portfolios, according to MFS fixed income portfolio manager David Cole.

Like equities, Cole notes that active share can provide valuable information on the drivers of risk and return. MFS research shows that a diversified high-yield credit manager can be active despite a low tracking error. “This is consistent with a high-yield manager’s investment process, which frequently entails minimising systematic risk while seeking to maximise returns from the security selection process,” he adds.

Quoniam Asset Management is also looking at developing an active share approach for credit portfolios. “We are in the process of working on a final version,” says Fang. “The measure will not just be based on weight as in equities but on other factors such as duration to help our clients better understand what managers are doing.”

TRACKING ERROR MAINLY INDICATES FACTOR BETS WHILE ACTIVE SHARE REFLECTS SECURITY SELECTION

Meanwhile, Fidelity International is honing its own approach across the fixed income universe. “To calculate active share of fixed income portfolios, we assess the level of activeness across four dimensions: duration, currency, credit selection and beta-adjusted credit selection,” says Fidelity investment risk director Tim Craigen. “We then adapt the calculation method for each dimension. For instance, to estimate active share of duration, we divide the portfolio (and index) into several buckets on the basis of currency and maturity, and then aggregate them on the basis of contribution-to-duration.”

He adds: “For credit, we simply apply the same approach as used in equities, with market weights applied on an issuer basis with no discrimination between maturity and currency of bonds held. For beta-adjusted credit selection, we assess the duration-times-spread contributions per issuer and compare that to the index. This helps to understand whether a portfolio has any beta bias that introduces significant active risk.”

As with equities, Craigen believes a combination of measures should be employed to measure performance. “In this low yield, low spread and low volatility environment, there is a risk that tracking error measures understate or misrepresent the true active risk that lurks within a bond portfolio,” he adds. “We only need to cast our minds back to the financial crisis of 2008/9 to remember the limitations of tracking error models, particularly those that rely on historic data” he adds.

However, there is of course no free lunch. “The active share can be a useful and complementary way to assess the ex-ante activeness of a portfolio and to ensure its sources of active risk are appropriate and intended,” says Caigen. “It should not be viewed as a panacea however, as there are dangers in crudely applying an equity measure in a fixed income world.

Dobrescu also sounds a note of caution. “Investors should not equate a high active share rating with future outperformance,” she adds. “It just means that the fund’s returns are likely to be very different from the benchmark, for better or for worse. Other factors such as tracking error, manager’s skill and the level of risk should also be taken into account.” ■

INTERVIEW

Running with the baton

Natalie Tuck speaks to PensionsEurope secretary general/CEO Matti Leppälä on the association's current work and its view on how the European pensions sector is shaping up

WRITTEN BY NATALIE TUCK

When it comes to developments in the European pensions sector PensionsEurope is no spectator; it actively plays a part in the relay race of pension policy with its teammates, the European Commission, European Parliament and the European Insurance and Occupational Pensions Authority (EIOPA).

Given it sits outside the European Union, it will never be the anchor leg, the final runner in the race, but it will always have a part earlier on in the process. For example, earlier this summer it published two reports, one on securing good member outcomes and another on the framework for a modern pensions solution.

PensionsEurope secretary general/CEO Matti Leppälä says the reports were produced by two of the association's committees, one for defined benefit pensions and one for defined contribution pensions, which "aim to be thought leaders on these issues".

"I think the papers have been well received, particularly by EIOPA, as they present the views of pension funds and the views of service providers such as asset managers and consultants etc. They are sensible papers that present basis ideas for developments."

Of course, Leppälä does not yet know what the impact will be, but he feels that there is a need for a body like PensionsEurope to undertake this type of work, "to think ahead and present ideas that may be picked up by EIOPA".

Good working relationships

When it comes to the European Union's insurance and pensions regulator, EIOPA, Leppälä says the association has a "very good working relationship", although acknowledging that they "don't agree on everything". He believes the open dialogue is beneficial to both sides, as it helps EIOPA to "have the view and information from the industry".

One of the issues currently up for debate involves the work with EIOPA and the European Central Bank (ECB) on pensions information reporting. The ECB, in coordination with EIOPA, is consulting on draft regulations on statistical reporting requirements for pension funds. It aims for better quality, more granular and comparable statistical data on the sector, provides for a better understanding of its role in the transmission mechanism of monetary policy as well as of cash flows and risks associated with pension obligations.

Leppälä describes it as a "big issue", but PensionsEurope has worked closely with the ECB and notes that it has taken the association's concerns seriously. One of these concerns was how liabilities should only be reported once a year and not on a bi-annual or even quarterly basis as the ECB first suggested. It is also of paramount importance that liabilities will be reported based on member states' existing prudential rules and not on any harmonised European framework. Separately, EIOPA is consulting on the streamlining of pensions information so there will be a single flow of information.

"We will be asking our members for comments, but at this stage I think the concerns will be whether it will be too complicated or too costly. It's difficult to know what the benefits are." However, he adds that it will be beneficial for the supervisory authorities to have the correct information on pension funds. "It is essential that the information which they base their policy thinking on is correct."

The European Commission has also recently published its proposals for a Pan-European Personal Pension Product (PEPP), which the association hopes will be a success. However, Leppälä is not adverse to the difficulties in creating such a product, and stresses that the tax treatment of the product will be essential in determining its success.

"If there isn't tax support for the product, I think it will be very difficult for people to save in this for a pension. In all well-functioning personal pension products the tax treatment is essential." He also notes that the need for a PEPP will be greater in some member states than others.

Room for improvement

Despite all the progression made, there is still much room for improvement in the sector, along with the threat of the impact of the UK's decision to leave the European Union. The latter is something PensionsEurope says is a "big one for us". Not only is this to do with concerns over the details of the pension rights once the UK leaves the block, but the association feels it will be losing a "big voice" when it comes to progression.

"The UK is obviously the biggest occupational pension country in Europe, it has more assets than any other country and has supported the development of European pension policy, pension legislation and investment legislation. It has promoted and defended occupational pensions, so if and when that voice is no longer there then of course we are concerned what will be the impact," Leppälä says.

When it comes to other issues, Leppälä notes that workplace pension coverage is still inadequate across Europe. Despite improvements in some member states such as the UK with auto-enrolment and Germany with the introduction of defined contribution pensions in the workplace, Leppälä says it is still a big issue.

"It is very clear that we need more funded pensions; we have seen first and foremost that it would be a good solution to promote further good quality workplace pensions[…] Overall the lack of coverage and the low level of pension saving remains the main problem and much more needs to be done at European and member state level to increase this."

Furthermore, with the increasing popularity of defined contribution pensions, Leppälä acknowledges that there is a lot of work to be done in the decumulation phase of pensions. "We have many members who are dealing with this issue, and what kind of options there should be in the decumulation phase," he says.

"What I have heard from schemes across Europe and from members is that they would like to have different options, not just annuities in the decumulation phase. Perhaps taking investment risks in the pay-out phase, or maybe having partially, some deferred annuities, there are many different models." However, Leppälä notes that it is not an easy issue and there is a lot to be debated, such as who bears the risk.

Looking ahead

One piece of regulation that has made the finish line is the IORP II Directive, which was voted in by the European Parliament towards the end of 2016. At the time member states were given until January 2019 to transpose the directive into their national law.

Alongside the working group set up by the European Commission with member states, which the association has no involvement in, it has its own working group. Many of its members participate in the group, which allows them to share information as to how they plan to implement the directive.

Leppälä stresses that as it is a directive, it is not fully harmonised, and so will be transposed in many different ways in the member states. "We have asked our members for estimations, what we call a gap analysis, of what they think is missing from the present legislation in their countries. In many cases they themselves interpret that not much needs to be changed."

However, there are some issues such as ESG and climate change, risk management and the pension benefit statement, where it is clear that everybody needs to add something to the existing legislation, but that estimation is different from country to country. "I'm sure the member states' governments are doing this same exercise and they have their own ideas of what needs to be changed," Leppälä says.

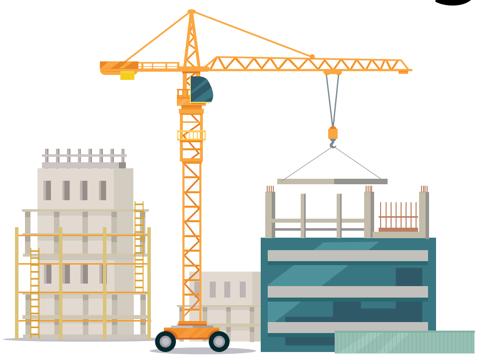
In terms of progression, it is Belgium which is aiming to move really quickly. "At our last meeting, the information we received from our pension members in Belgium was that they were planning to submit legislative proposals during the summer. However, I'm not sure of the progression."

On the other hand, Italy has made it clear that it will not propose any legislative work before next year, but the Italian members believe that not much needs to be changed in terms of Italian law. There is also the question of whether the UK will transpose the directive into UK law, given that it is set to depart from the Union in March 2019.

For now, PensionsEurope will continue working with the members to help them implement the directive along with its dedication to improving pensions for everyone across Europe, which of course, is a marathon, not a sprint. ■

INVESTMENT

Learning to love big projects



With cash-strapped governments seeking funding for major infrastructure developments, Graham Buck **asks if they can attract more investment from European funds**

WRITTEN BY GRAHAM BUCK, A FREELANCE JOURNALIST

The next 10-15 years will be a period marked by massive new infrastructure projects around the world, each competing to attract investors so that development progresses beyond the drawing board. At the start of 2013, a McKinsey *Global Institute* report calculated a total funding requirement $57 trillion to realise planned new global infrastructure over nearly two decades to 2030.

As the authors noted, finding all of the funding would be challenging - the estimate representing an increase of around 60 per cent over the $36 trillion that had been spent in the preceding 18-year period. Yet, if anything, the figure was overly conservative and didn't extend to the cost of addressing past backlogs in repair and maintenance work, or of 'future proofing' infrastructure against the impact of factors such as climate change.

The need to construct and modernise infrastructure applies just as much to Europe, where even its biggest economic power is faced with the need to upgrade crumbling bridges, roads and railways. Germany's transport infrastructure, which in 2006 was ranked third-best in the world by the World Economic Forum's *Global Competitiveness Report*, had slipped to 13th position by last year.

This demotion prompted a pledge from the Federal Ministry of Transport and Digital Infrastructure to spend €269 billion on Germany's infrastructure over the next 15 years, with around 70 per cent of that figure earmarked for maintenance rather than new projects.

With Europe's governments as cash-strapped as their peers around the world, can pension funds help ease the continent's funding crunch? Mercer's 2017 edition of its annual *European Asset Allocation Report* found that equity allocations - particularly among UK plans - have steadily declined in the past 10 years since the financial crisis alongside a growing interest in "alternative assets that offer some additional return in exchange for reduced liquidity and greater complexity, as well as providing a regular income stream". These included infrastructure, alongside private debt and secured finance.

BlackRock head of infrastructure debt for Europe Jonathan Stevens says that the group expects to see global investment activity measured in the hundreds of billions per annum and Europe to be a significant component. "Investment returns in Europe may be lower than in the US or Asia, reflecting both the yield curves and prevalence of lower risk structures - public-private partnership (PPP), feed in tariffs, and regulated utilities - but Europe can still offer attractive relative value to an investor, once one factors in the potential cost/benefit of cross currency hedging," he suggests.

Over the summer, the European Commission unveiled its cross-border pension initiative, dubbed the Pan-European Pension Product (PEPP). The basic goal of the PEPP is to offer savers across the EU improved options when planning for their retirement, but EC vice-president Jyrki Katainen confirmed that it also aims to channel savings towards long-term investments as part of efforts to upgrade infrastructure, boost growth and support jobs.

A tough sell

Attracting pension funds to invest in infrastructure has certainly proved difficult in the UK where, in the coalition government's early days, George Osborne announced an initiative to "unlock" around £20 billion for major new transport and energy projects. While London's Crossrail scheme is on track seven years on, reports suggest that the resulting Pensions Infrastructure Platform (PIP), set up under the auspices of the Pensions and Lifetime Savings Association, has attracted no more than £1 billion in investment; most of this going to secondary schemes rather than those championed by the former chancellor.

The disappointing performance owes much to the UK's trend of declining defined benefit scheme provision being replaced by defined contribution pensions, suggests Hargreaves Lansdown senior pension analyst Nathan Long. "The illiquidity of infrastructure investments make them generally ill-suited to defined contribution pensions, especially when the new pension freedoms now make it far easier for large chunks of money to be withdrawn from pensions," he notes.

"In addition, whilst infrastructure itself is often perceived as an attractive asset class, the reality is that many infrastructure projects, particularly in their infancy, can be capital intensive with returns not realised for many years to come."

However, Macquarie Infrastructure Debt Investment Solutions (MIDIS) director Tim Humphrey reports that attitudes are changing. The Australia-based international investment banking and financial services giant set up MIDIS in early 2012 as its investor-aligned global infrastructure management arm and Humphrey reports that early mandates were fairly restrictive in their investment guidelines, focusing on more conservative projects such as hospitals and schools.

"Infrastructure debt has since become much more of an established class," says Humphrey. "So pension funds have been looking at areas such as renewables and also at the more complex deals in areas where there is less competition."

He adds that support for "more challenging" projects, such as the £4.2 billion Thames Tideway scheme to provide London with a major new sewer from 2023, evidences a growing willingness to invest in infrastructure that may not start producing returns for several years.

Looking further afield, while the amount involved might seem relatively small change, the recent decision by Dutch pension fund ABP to invest €700 million in 48 infrastructure projects across Europe was nonetheless welcome news. The portfolio social infrastructure developments such as schools and hospitals to renewable energy schemes focused on solar and wind power.

Most recently, Danish funds PensionDanmark, PKA and Lægernes Pension partnered with the newly-created AP Møller Capital - established by the transport conglomerate Mærsk - to commit $550 million to an Africa Infrastructure Fund, a figure that could nearly be doubled if it manages to attract other Danish and international investors. Africa Infrastructure Fund I is scheduled to run for 10 years and will provide funding for 10 to 15 projects, with a focus on transport and energy.

Research by investment boutique Aurium Capital Markets also supports evidence of a growing readiness by pension funds to consider infra-structure as more "focus on investment opportunities that have low correlation with equities and bonds, and which can provide a steady and attractive long-term return."

Might other European funds follow the Danes and look beyond home for investment opportunities, perhaps to the world's two leading economies? China's ambitious 'belt and road' initiative is already well underway, while Donald Trump's surprise election victory in the US was helped by his pledge to spend big on infrastructure projects.

"There will certainly be a fair degree of interest generated from these two initiatives," says Allianz Global Investors head of UK institutional Margaret Frost. "But the outcomes will be highly dependent on a number of factors, in the case of the US, for instance, whether President Trump can actually deliver on this infrastructure spending is bound to be highly contentious and likely to be held up by the legislative process as have many other initiatives attempted thus far in his presidency.

"In the case of China's ambitions, we would expect that concerns over a lack of transparency, legal and jurisdictional ambiguities would make major allocations to these types of projects very problematic for European pension funds from a compliance perspective."

Does this mean that European funds will stick closer to home and restrict their investment to the more conservative projects?

"At first, we saw European pension funds focused on higher quality, core infrastructure assets that provide a stable cash flow profile through long-term contracts," reports Stevens.

"There is still significant demand for these projects, however, more recently, we've started to see them taking on more risk in the form of high yield debt and core-plus equity projects. This is, in large part, a result of increasing comfort with the asset class, and the need to diversify core equity returns that have compressed in recent years.

"In addition, pension funds are risk focused, but we wouldn't say they do not have risk appetite. A road financing with an availability based contract will have a much different risk profile than one with volumetric and tolling risk, and return should be commensurate with the risk profile of the project."

Frost reports that Allianz GI's experience to date has been that European funds tend to favour the more conservative projects, although "we expect a wider acceptance of possible deals as schemes become increasingly aware of and educated about the asset class." ■

In their own words...

Industry personalities' comments on the hot topics affecting the European pensions space

On investing in insurance-linked securities (ILS)

"Pension funds in Switzerland have known about and been invested in ILS for a very long time, some since the middle of the 2000s. One of the reasons is proximity. Some of the first funds dedicated to ILS were launched in Zurich. Most of the insurance and reinsurance industry is based around Zurich, and because of long historical ties between pension funds and the insurance and reinsurance industry, there was a pretty quick take up rate and a clear understanding of what ILS was setting out to do."

Scor Investment Partners head of ILS Vincent Prabis

On cross-border pensions

" It will be a matter for [Brexit] negotiation to see whether the EU and the UK can agree to a continuation of cross-border provision of insurance and retirement solutions. As the UK Financial Services industry has been seen as the jewel in the crown by much of the EU this is likely to be one of the most difficult areas of negotiation."

Fidelity head of international benefits consulting Mark Sullivan

On the changing nature of the UK's state pension system

HUGH NOLAN

The Society of Pension Professionals' president

"We do get a sense of people saying that they can't rely on the government to provide them with a decent pension. So my suspicion is that this will increase people's awareness of pensions and get them to save a bit more. On the grounds that if they want to retire at 65 rather than 68, then they'll think, 'I need to put a bit more aside for myself'."

TIM MIDDLETON

The Pensions Management Institute's technical consultant

"Pushing the state pension age back is going to divorce private saving from state pension provision, and that could create some problems later on."

On infrastructure investing

JONATHAN STEVENS

BlackRock head of infrastructure debt for Europe

"At first, we saw European pension funds focused on higher quality, core infrastructure assets that provide a stable cash flow profile through long-term contracts. There is still significant demand for these projects, however, more recently, we've started to see them taking on more risk in the form of high yield debt and core-plus equity projects."

On UK pension savers being targeted by scammers

TONY BACON

Lane Clark & Peacock senior consultant

"The problem of scams is increasing but it continually mutates, with the authorities at least one step behind. Fraudulent SIPPs (Self Invested Personal Pensions) or non-pension investment vehicles for money legitimately cashed out under freedom and choice may be bigger problems."

JAMES WALSH

Pensions and Lifetime Savings Association (PLSA) policy lead, for EU and international

"It's been too easy to set up a scheme and register it for tax, which many people will think is a seal of official approval, but of course it's nothing of the sort. We should get to a situation where people know that if a scheme is approved by the government then they can trust it with their savings."

On the Netherlands' attempts to fairly share pensions risk

FRANCOIS BARKER

Eversheds partner and head of pensions

"The Netherlands is doing what the rest of the world is doing: concluding that DB in its traditional form puts all the risk on the individual employer and we need to find ways of sharing risk. What marks the Netherlands out is its strong basis of strong partners and the collective fabric of society which means it is not going to do what the US, UK, Australia and Germany have done and move right to the other extreme."

CHARLES COWLING

JLT director

"Unlike the UK, where there is quite a lot of angst and antagonism between management and unions and to some extent companies and trustees … the idea that trustees of a pension scheme could bring down a company is completely anathema to the Dutch. They would sit around a table and find a way forward that is fair to everybody. The Dutch way of doing things won't necessarily translate to other countries. It fits with the greater collective equality, sharing, society, rather than the 'me first' society that we have in the UK."

On EIOPA's plans to streamline pensions reporting

"There is a need for better, comparable and relevant information regarding occupational pensions in Europe which is decisive to take informed policy decisions."

EIOPA chairman Gabriel Bernardino

On property investment

"Fund managers are looking at different markets and regions. Where once they may have gone for core properties, they may now go for core-plus properties. A core property is an asset that has strong tenants in a prime location, making a consistent income stream. A core-plus property means it might need some renovations and improvements in order to bring it up."

Preqin head of real estate product Oliver Senchal

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