PENSION FUNDS

How EU pensions are coping with the economic shift

Falling investment returns and rising inflation have created challenges for pension funds, but higher funding ratios have put many in a better position

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Post-Covid, there has been a fundamental economic shift as higher inflation and rising interest rates have returned home amid increased geopolitical risks. Like their peers around the globe, this has presented many challenges to pension systems and funds in the EU. Pension systems across Europe are affected very differently depending on whether they are capital-based or pay-as-you-go.

Capital-based systems, which are mainly concentrated in the Netherlands and the Nordics, are mostly affected by movements in financial markets and inflation. Pay-as-you-go systems in countries like Germany and Italy are impacted more by the continued ageing trend.

The budgetary challenges of countries, especially in the southern part of Europe, have become more pronounced, says APG Asset Management managing director of strategic portfolio advice, Onno Steenbeek: “Compensating for inflation has become less automatic, which is a problem when inflation becomes as high as it was over the past 12 months.”

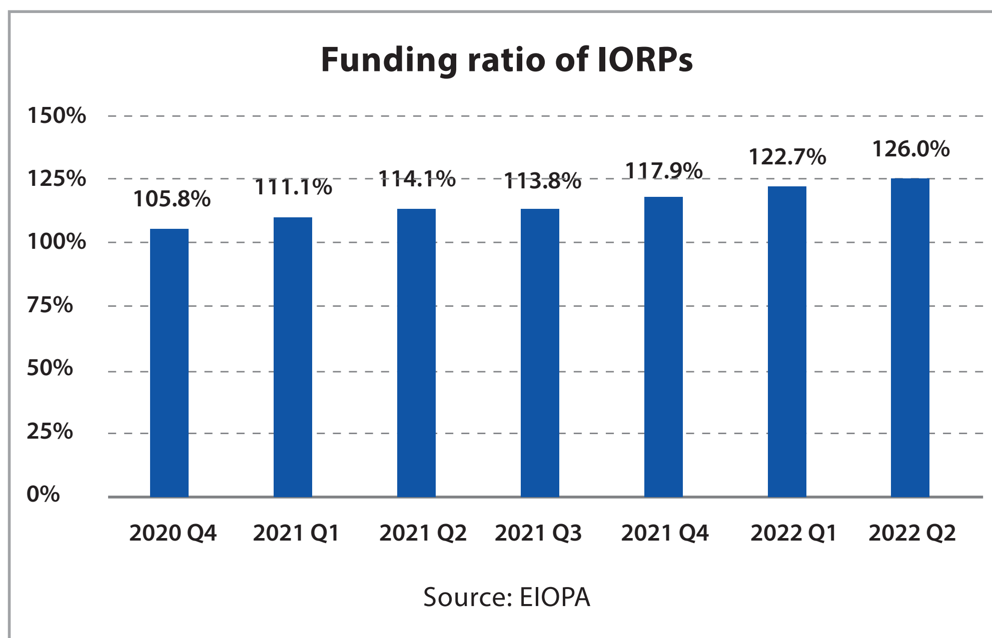
PensionsEurope secretary general/ CEO, Matti Leppälä, adds that, all in all, the crisis has been severe for the real economy and for pension funds: “Public debt levels have gone up and sustainability of public finances is at stake, and social security pensions are a big part of public finances.”

Capital-based systems experienced a strong tailwind for many years, during which most asset classes performed well. We are now in a different environment, and we need to get used to that, says Steenbeek.

Investment returns fell in 2022, with losses especially in listed equity and government bonds, but less so in private equity, real estate and corporate bonds.

“By the end of the third quarter of 2022, private assets fared much

better than the publicly listed assets or fixed-income instruments, but still made huge losses over 2022," adds Leppälä.



Funding ratios improve

While investments have deteriorated, the value of liabilities has declined even further, improving funding ratios. In countries using a market interest rate to determine funding ratios, capital was lost, but funding ratios rose. This means that in countries like the Netherlands, which is the biggest euro area pension fund country, the situation is much better than it was when the markets were providing the best-ever investment returns, says Leppälä.

According to the European Insurance and Occupational Pensions Authority (EIOPA), the funding ratio of IORPs across the EU rose from 117.9 per cent in Q4 2021 to 122.7 per cent in Q1 2022, and then to 126 per cent in Q2.

EIOPA said the recent improvement of the funding ratio is the result of increased interest rates, which led to a decrease of the technical provisions, offsetting the drop in assets in the first and second quarters of 2022.

Among the corporate pension funds in the German DAX 40, Mercer estimates that their liabilities fell from €400 billion to €300 billion, while funding levels increased from 70 per cent to 82 per cent.

Steenbeek says the equity, fixed income and interest rate swaps portfolios of pension funds serviced by APG were hit in 2022, but these were more than compensated by the rise in interest rates.

"Pension funds serviced by APG jointly lost 10s of billions of euros in capital by the end of the year, but funding ratios rose by 25 percentage points," he says.

Higher funding ratios have enabled Dutch funds to provide inflation indexation of 10 per cent or more – levels not seen in decades.

The Dutch DB schemes have a nominal promise where inflation is only provided if the funding ratio rises beyond a certain level. By providing 10 per cent indexation or more, the funding ratio drops by the same amount, so the buffers have taken a big hit.

"The general expectation at APG is that inflation will gradually come down, maybe slower than we originally thought, but we believe that eventually the European Central Bank will keep inflation just below 2 per cent," says Steenbeek.

> "PUBLIC DEBT LEVELS HAVE GONE UP AND SUSTAINABILITY OF PUBLIC FINANCES IS AT STAKE"

Pension funds are reacting to their improved funding situation in several ways. Mercer European head of investments, Eimear Walsh, says given that inflationary increases aren't mandatory in a lot of countries across Europe, corporates could think about increasing the indexation with inflation to pass on more inflation protection to their members.

She says: "Funding liabilities are not mandatory in Germany, so now that affordability is increased, corporates could take this opportunity to potentially fund their pension scheme. We're talking to a lot of clients in Germany about this."

Hedging opportunities

Schemes that have seen their funding levels rise could look to bank in some of their gains by hedging both interest rates and inflation. Liability-driven investment (LDI) strategies are being treated with high caution

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given the crisis that unravelled in the UK last year.

"But unlike the UK, across Europe, hedge ratios haven't been that high in general and there haven't been a lot of leveraged instruments in the system," says Walsh. "The Netherlands and Ireland are the only countries that use leverage to a degree."

But she thinks now is an opportunity for clients to think about increasing that to lock in some of these gains through physicals: "We have clients in Ireland that are looking at moving to cashflow-driven investment strategies, so increasing their corporate bond exposure and physical gilts. And LDI is being considered but in a prudent way. If there's any leverage in the system, you need to make sure you have the collateral."

The economic circumstances have highlighted that liquidity management should be at the heart of the investment strategy.

Walsh says: "To make sure you reach your ultimate goal of paying members' benefits, you need to make sure you have cashflow available, particularly if you're increasing hedge ratios and also have allocations to alternatives."

One of the biggest changes is the appetite for buying bonds now that pension funds can get higher yields on government bonds, but also more spreads on credit.

"There's much more appetite to consider bonds now but done in line with pension funds' overall journey plan so they can still meet the return targets that they need, but also take down risk," comments Walsh.

Time to reassess role of alternatives

DB pension funds have been increasingly allocating to alternatives and private assets during the years of record low interest rates as they were forced to look for real returns.

Tightening quantitative easing has an impact on what happens in the investment markets, including alternatives.

Pension funds need to reassess how they invest in alternatives as the markets are changing, says Leppälä: "The role of the alternatives has increased in recent years, and with good results, but in this new situation, with different monetary policy and a possible recession, pension funds now need to think about the role of alternatives going forward.

"I'm sure that alternatives will continue to be very important for pension funds but as markets change, they need to re-evaluate what they need to do with those investments to see what makes sense going forward."

There is an interesting dynamic in multinational pension scheme arrangements right now, which is largely different from the UK. A lot of Mercer's UK clients are overweight to illiquid assets and are looking to decrease that allocation.

But there is a demand across Europe to bolster their illiquid asset allocation, says Walsh: "So, there's a different dynamic between what's happening in the UK and the rest of Europe from a maturity of pensions prospective. Unlike the UK, the buyout market in Europe isn't very active so most clients are targeting run-off and cashflow-driven investment portfolios for the long term."

However, Steenbeek does not expect significant asset allocation changes in response to the market developments of 2022. Despite pension funds benefitting from higher funding ratios because of rising interest rates, Steenbeek concludes that markets remain volatile and there still are "many uncertainties affecting market expectations".■