Pension: ‘Uncertain security’

Investment Policy and Risk Management Committee

An analysis of the investment policy and risk management of Dutch pension funds

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Summary

- **The pension fund sector is heterogeneous and increasingly complex.**
- **Low birth rates and population ageing are contributory factors in the increasing vulnerability of pension funds.**
- **Pension funds have structurally undervalued the importance of risk management and how investment policy is implemented.**
- **Real framework must serve as a guide; too much emphasis at present on nominal funding ratio due to FTK (Financieel Toetsingskader - Financial Assessment Framework).**
- **Specific characteristics of pension funds are not adequately translated into investment policy.**
- **Socially responsible conduct does not form an integrated part of risk management and investment policy.**
- **The governance model needs to be improved.**

These are the main conclusions of the Investment Policy and Risk Management Committee (hereinafter: ‘the committee’).
At the request of the Minister of Social Affairs and Employment, Mr Piet Hein Donner, the committee has examined how the investment policy, risk management, administration and governance of pension funds have developed since 1990 in relation to the aim and the risk acceptance level of pension funds.
Based on this study, which focused primarily on structural developments, the committee has formulated a number of recommendations, in particular for the governance of pension funds.

1. Analysis

Pension fund sector is vulnerable and this vulnerability is increasing

The vulnerability of pension funds has increased due to a combination of developments.

- Pension funds are faced with major challenges due to the low birth rates and ageing of the population. The combination of longer life expectancy and an unchanged retirement age makes pensions more expensive. Population ageing makes pension funds more vulnerable and erodes their ability to recover. The share of pension contributions decreases relative to the pension commitments and the duration of the pension commitments declines. It becomes increasingly difficult to deploy pension contributions as an effective control instrument.
- Pension funds are ‘ageing giants’: more than 60% of total pension assets is earmarked for pensions that have already commenced or will commence within 10 years. This means that the pension funds' investment horizon is becoming shorter, thereby affecting their ability to recover from negative investment results. Major disruptions in financial markets can turn ageing giants into ‘sinking giants’: institutions that are no longer able to meet their commitments.
- Pension funds have become more dependent on financial markets. They have invested ever increasingly in marketable securities such as shares, real estate and alternative investments. This partly arises from the need to achieve a higher return in order to keep pension costs low. This in turn has led to a considerable increase in the risk profile of pension funds. At the same time, it is expected that the pension funds will protect the accumulated pension entitlements and maintain the level of the nominal funding ratio. In times of crisis, the increased risk profile

can result in substantial decreases in the funding ratio of pension funds, as also happened in 2008. Crises will continue to occur and it is therefore important to make allowance for them.
- A major cause of the decreased funding ratios of pension funds is the drop in the interest rate they use to calculate the net present value of future pension benefits. Since the introduction in 2007 of the FTK (Financieel Toetsingskader - Financial Assessment Framework), pension funds are obliged to value their (nominal) liabilities based on the market interest rate (the term structure of interest rates). This makes their (nominal) funding ratio sensitive to changes in the market interest rate. Extreme falls in the market interest rate, such as occurred in 2008, are also accompanied by extreme increases in the value of the liabilities.

The pension sector is highly heterogeneous. Pension funds differ considerably in terms of their size, membership background, the degree of ageing, the funding ratio, the pension schemes they administer and their governance.

Importance of risk policy and how investment policy is implemented structurally undervalued

The increased vulnerability of pension funds means that risk policy is becoming more and more important. However, most pension funds still undervalue the importance of structural risk policy and how investment policy is implemented; the committee also notes that investment policy is usually return-driven.
In conducting their investment policy, pension funds focus primarily on strategic and tactical decisions. This means that choices are made with regard to the classes invested in, how the investments are spread across various regions and which risks may possibly be covered. The actual management of the assets is outsourced en masse. Too little attention is paid to the risks of outsourcing and retaining a ‘grip’ on outsourcing. However, there are many risks attached to the implementation of the investment policy, and certainly when it is outsourced, due to the existence of asymmetrical information and a difference in the interests of the outsourcer and the administrator. Substantial losses can be incurred when implementing the investment policy; these losses are known as ‘implementation shortfall’.

Real framework must serve as a guide

Pension fund has real objective
Pension funds generally administer a pension scheme in which the accumulated nominal pension entitlements are unconditionally promised while the future indexations are conditional. Members expect, however, that their pension entitlements will more or less keep pace with the trend in prices. From the member's viewpoint, only an index-linked pension has value in economic terms. It is expected that the accrued nominal pension of participants below the age of 40 will have lost roughly half its purchasing power on the commencement date if no indexation has taken place in the meantime. Pension funds also consider preservation of purchasing power to be the norm and that anything less than full indexation should be the exception.

Too much emphasis placed on nominal funding ratio
The statutory funding and financing requirements for pension funds only relate to unconditional commitments. De Nederlandsche Bank (Dutch Central Bank - DNB) assesses, based on the FTK, the financial position of pension funds from a nominal perspective. Conditional pension entitlements, such as future indexations, are then disregarded.
One consequence of this nominal assessment framework is that pension funds focus relatively one-sidedly on the nominal risk and will attempt to control the nominal funding ratio risk. This can have a negative impact on the development of the real funding ratio and the real funding ratio risk. The FTK, which was introduced in 2007 and which has in itself had a positive and disciplining effect, is too one-sided in this regard and should be developed further.

The committee is of the opinion that, given the large social importance of indexation, the real framework must serve as a guide in terms of the risk management and the investment policy of the

pension funds. In other words, the fund has a real aim and the nominal funding ratio is no more than a limiting condition that must be fulfilled based on external regulations.
Measuring and controlling the interim solvency risk are very important, since interim solvency provides important information about the probability distribution of the pension result that is eventually to be achieved. This is of particular importance to pension funds with an ageing membership. Their shrinking time horizon requires them to make timely adjustments.

Specific characteristics of pension funds still not adequately translated into investment policy

Pension funds operate in the long term with a real aim as regards the pension benefits to be provided and, in the interim, have to deal with the nominal funding ratio risk. Many pension funds base their investment policy on either the long-term return or on the interim funding ratio risk. The committee has nonetheless not been able to identify a statistically significant relationship between the investment policy and the characteristics of the pension fund, such as the extent of ageing and the size of the funding ratio. It has become evident to the committee from discussions with experts and other relevant parties that several pension funds do not follow a consistent course of action in this regard and shift the direction of their investment policy based on interim developments.

Socially responsible conduct does not yet form an integrated part of risk policy and investment policy

As assets invested by pension funds have increased so too has the focus increased on the social role of the pension fund as an investor. Its statutory mandate requires pension funds to use the pension assets to ensure a good and safe pension. The pension fund can therefore not avoid being aware of the broader social consequences of its conduct. Society and political bodies expect companies, and also pension funds, to pay explicit attention to sustainability issues in relation to the environment and the climate but also in the field of human rights and social relations. In addition to this external validation of socially responsible investment, there are also internal reasons for such conduct. Firstly, there are the preferences of the members; these must be embedded in the pension fund's policy, also in terms of investments. Furthermore, the fund, as a long-term investor, is directly affected by the consequences of non-sustainable ecological, economic or social developments on the future value of investments. A sustainability policy must therefore be an integral part of the risk and investment policy.

Governance model in need of improvement

The challenges facing pension funds have far-reaching consequences in terms of governance. Increasing complexity is continually raising the governance bar. The report includes a systematic analysis of the challenges facing pension funds and the common practices accompanying them. The question is how to cope with these challenges and common practices from the viewpoint of governance.

The boards of pension funds must independently balance expected return against determining what constitutes an acceptable risk, given the pension contract, the risk acceptance level and the appetite for risk among the members and other stakeholders in the pension fund. They must be able to independently determine the direction and to take the necessary initiatives in good time in order to adjust the policy.

The governance role has changed in recent years from a paternalistic trustee model into a democratic trustee model in which expertise, transparency of and accountability for the conduct of governance take centre stage. It is no longer the composition but rather the position and definition of roles in the board that are the determining factors. The key points in this regard are actual independence and expertise.
The complexity and scale of the governance duties call for adequate and professional support. Small pension funds in particular can have difficulty coping with the expense this involves.

Pension funds will have to evaluate regularly how they function in terms of their governance, particularly in relation to the key points referred to above. Communication and accountability via website and annual report are similarly core responsibilities of governance.

In conclusion

Based on its study, the committee has not found any evidence that pension funds perform poorly on a structural basis. Nonetheless, it is clear that 2008 was a very bad year and that pension funds face uneasy financial times in the coming years. The developments that have been outlined place higher demands on pension fund governance and on the quality of the governance process.

The committee therefore makes recommendations for (strategic) risk policy, investment policy, socially responsible (business) conduct, the implementation of the investment and risk policy and, finally, the definition and implementation of the governance responsibilities. The committee calls on the sector organisations and the boards of pension funds to act on the recommendations and to develop them into a set of best practices. The committee therefore argues in the first place in favour of self-regulation, not as a process free of obligation but as a firm commitment from the sector.
In addition, the committee advises that legislation and regulations be amended or tightened up in a number of areas. These mainly include incorporating a real framework in the FTK as well as requirements in respect of the expertise of pension fund boards and the governance of pension funds. The committee also considers it important that the Pensions Act (Pensioenwet) should leave room for changes in the liability structure so as to allow the explicit allocation of risks to the different groups of fund participants.

The committee is fully aware that it is making high demands on the governance of pension funds, since the feasibility of the implementation of the recommendations depends also on the possibilities of adjusting the pension contract to take account of the changed relations and the increased vulnerability. However, this did not fall within the committee's terms of reference.

2. Recommendations

Based on its analysis, the committee has formulated the following recommendations:

Risk management

1. Boards must only accept pension contracts that are not only explicit and well-balanced in terms of the pension commitments and the agreements on contributions, but also in terms of the allocation of risks.

2. Boards must establish a strategic risk framework laying down an appropriate balance for the fund and the members between return and risk. The appetite for risk and the risk acceptance level among the members of the fund must be defined and should form the starting point for the investment policy to be pursued. A situation whereby the investment policy is in fact mainly return driven should be avoided.

3. The board of the fund should ascertain what the attitude of the members of the fund and the contributing employers is with regard to sustainability. This should then form the starting point for the risk and investment policy. Each year the board renders account with regard to the sustainability performance of the investments.

4. A real aim must serve as a guide. The pension fund must develop an assessment framework in which both short-term funding ratio risks and long-term indexation risks are taken into account. This must be detailed and given concrete form in an ALM context, with the liability structure acting as reference point.

5. The board must ensure that even under extreme market conditions, the fund does not drop below the critical nominal or real funding ratio. The board must determine the lower limit for the nominal and the real funding ratio based on the specific characteristics of that fund and the risk acceptance level and risk appetite of the fund members.

6. The board must render account to the members with regard to the strategic investment framework and the exchange of return against risk that has been opted for within that framework and with regard to the shape and details of the accompanying risk management. As a mandatory element of this accountability, the fund should inform the members via the website and at least yearly via an annual report about the presumed risk appetite of the members, the current risk profile, the effective nominal and real funding ratio as well as the critical lower limit for the nominal and real funding ratio set by the board.

Investment policy

7. The investment policy must be aimed at achieving a correct balance between the real objective (ambition) and the interim nominal and real funding ratio risk. The investment policy forms an integral whole with the risk and sustainability policy. The strategic risk framework and the investment policy are determined in combination with one another.

8. The board must base the investment policy on current and realistic return and risk expectations. In particular, the board must satisfy itself that critical funding ratio limits are not exceeded, even under extreme circumstances.

9. The board must make explicit choices regarding the structuring of the investment policy in all its aspects and must render account in this regard. The board must take a critical stance with regard to the assumed benefits of alternative investments and forms of active investment policy and must analyse and identify the burdens and risks of that policy in addition to the expected benefits.

10. The board should adopt a monitoring framework in order to be able continuously to assess the result of the investment policy relative to its real aim.

Implementation of risk management and investment policy

11. The board must be effectively in control with respect to risk management at all stages of the investment process. This applies to the implementation of the strategic, tactical and operational investment policy. The board should set this out in an in control statement.

12. The results of the investment policy must be put against the aims, the risk profile and the risk acceptance level as they have been determined based on the pension contract.

13. The information processes must be structured in such a way that the risks of asymmetrical information are reduced to a manageable level. This requires that management monitoring processes be organised in such a way that this yields actual insight into and transparency of risk management and the entire investment process. Additionally, it requires the selection of executors who fit the selected investment policy.

14. The board must be able to form an effective countervailing power to the professional executors and (commercial) providers of investment products. This also applies in the event that implementation takes place in house.

Governance and organisation

15. The board must demonstrably have expertise/skills in the field of risk management and asset management that enable it to act pro-actively.

16 The complexity of the investment policy and the risks must be tailored to the pension contract, the risk acceptance level and the risk appetite of the pension fund as well as the management expertise available within that fund.
It is recommended that a standard (default) approach for investment policy and risk management be developed that is simple and easy to explain to members and other stakeholders. It is possible to deviate from this approach provided that this is demonstrably based on the expertise present in the board.

17 Boards of small funds must regularly consider whether the fund is not becoming too small in size to guarantee that its board can be optimally staffed and its administrative processes can be optimally structured. The decision to continue as an independent pension fund should be balanced against the alternatives available. The board should render account with regard to the outcome of its deliberations in this respect to the members.

18. The board must render account with regard to the policy conducted, among other things by informing the members in explicit and specific terms via the website and at least yearly via the annual report about the policy and the results of risk management and asset management.

19. The board should develop, employ and safeguard a monitoring framework showing to what extent the board functions adequately in respect of the determination, structuring and implementation of:

- Risk policy
- Socially responsible conduct
- Investment policy