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DUFAS

New pension contract: a call for action for all asset managers

July 2020

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What is the impact of the new pension contract on investment management?

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Mere days before the FNV union voted in favor of the New Pension Contract, DUFAS and Deloitte organized a webinar on the impact it might have on asset management. Three Deloitte partners successively gave an outline on the NPC, the key changes to the pension system as we know it, and the reasons for these changes. They also discussed the impact of the new system on the operating model of the asset manager, as well as on market dynamics. The webinar was led by Iris van de Looij, director of DUFAS (Dutch Fund and Asset Management Association).

Contact persons:
Jan-Wouter Bloos, Marieke van Eenennaam & Robert-Jan Hamersma

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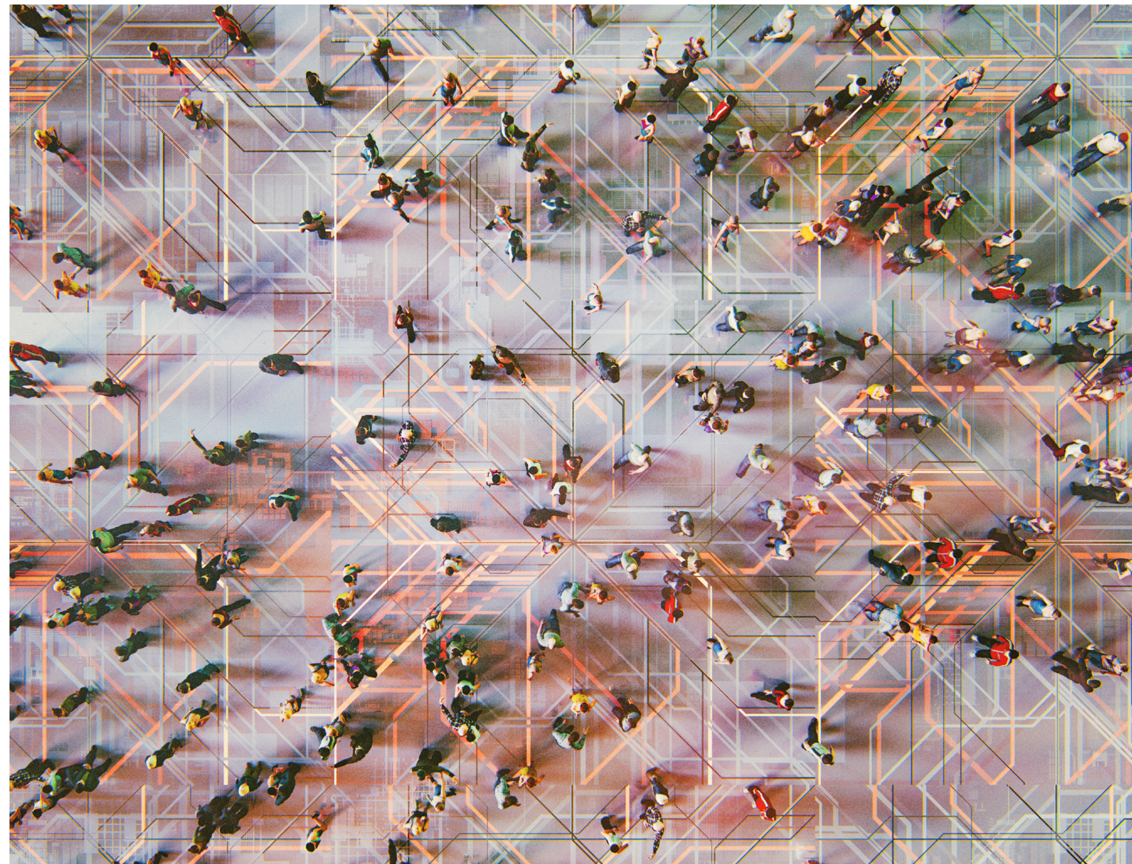
Rationale for pension reform

More than a decade after the first talks about reforming the Dutch pension system started, the sector finally presented an outline of the way forward last month. What is going to change? Is it an actual improvement? And how will the pension reform and new pension contract affect asset managers?



The reasons for the forthcoming pension reform are unequivocal, according to Robert-Jan Hamersma Partner Investment Management & Pensions – Benefits & Pension Advisory.

“Over time, the solidarity between younger and older generations has eroded, employees no longer work for the same employer for their whole lives, we live longer and the number of pensioners will only increase. All of this, combined with the low interest rates, make defined benefit (DB) schemes unsustainable.”

The reform means transitioning from equal accrual for all ages to an equal premium for all ages. Everybody will have his or her personal pension pot. Concepts like the coverage ratio (“dekkingsgraad”) for pension funds and the use of the technical interest rate (“rekenrente”) will disappear, affecting all kinds of pensions - not just DB schemes. Pension funds will have a choice of two contract options: the new pension contract (NPC) or the improved defined contribution plus (improved DC+) scheme. The transition should be completed by January 2026.

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Robert-Jan Hamersma:
"The largest, much needed, pension reform we have seen in decades, also creates a big challenge for the transition into the new system ("invaren") for all stakeholders involved."

> Key elements in the NPC are that the premium is invested collectively, the return on assets is spread over generations, and retirement benefits will increase and decrease depending on the economic circumstances. Instead of accrued benefits, everybody will have their own personal share in the collectively invested capital.

To prevent bad and good luck generations, the NPC has an obligatory solidarity reserve ("solidariteitsreserve") with a ceiling of 15% of this collective capital. A predetermined key will make it possible to attribute positive or negative investment returns over a period of ten years . The transition challenge is formidable. Essentially, all pension accruals will transition ("invaren") into the new pension contract. Conversion of accrued benefits to an individual capital entitlement is complex and sensitive. The transfer implications for all age cohorts will need to be reviewed. Compensating the cohort of around 45 years of age will be inevitable.

The improved DC+ scheme, on the other hand, is similar to the currently existing DC schemes that rely on individual capital, with at least two significant changes. Like with the NPC, the premium for DC schemes will shift from an age-dependent premium to a flat rate. Moreover, investment of capital after the retirement date ("doorbeleggen") will be the future default. People can opt out of this. Only those opting for an annuity pay-out will be able to 'shop' for this in the market. As a transitional measure, existing DC schemes (with age-dependent premiums) are allowed to be continued for the current workforce, but a flat rate DC scheme will have to be implemented for new employees. However, this increases the administrative burden for employers as they will be running two schemes. Besides, older employees will become more expensive. They are less likely to leave the company as they will have to change to a flat rate scheme with any new employer.

But not all is clear yet. Not much details have been made available yet about the future of insured DB schemes, which many companies still have in place. The transition for those schemes will be expensive, as no collective capital is available to be distributed for the transition.

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Changing perspective on investment risk, strategy and transparency

Marieke van Eenennaam:
"One thing stands out – investing will become more important under the new pension contract. This will be accompanied by new responsibilities and a focus on transparency and communication."

The NPC will have a profound impact on the operating model of asset managers. Throughout the nearly ten years of preparation for thepension reform, the focus has predominantly been on administration and conversion of pension rights.

Only now when clarity on the main pension themes and agreement are in sight the asset management community can start thinking about the implication. One thing stands out: investing will become more important under the new pension contract as we will shift away from a focus on coverage ratios to investment returns and from managing regulatory to economic capital, explains Marieke van Eenennaam (Partner, Deloitte Risk Advisory).

A key change in the new pension contract is that the interest rate risk will no longer be carried by all participants in solidarity. Pension funds, in consultation with social partners, will determine to what extent age cohorts will need to be protected against interest rate risk. A protection return ("beschermingsrendement") will be included to safeguard against interest rate shocks. This could lead to eliminating the interest rate risk protection for the 25 to 40 age cohort altogether, if the chosen risk behavior allows.

The emphasis will shift to creating investment strategies with optimal returns, taking into account risks associated with the age cohort to which a participant belongs. We expect the increased risk budgets to trigger an increase in equity and illiquid investments. We believe that diversification will remain a cornerstone of investment strategies under the new pension contract. Both alternative and illiquid investment strategies will become even more important for long-term pension investors. The same goes for the importance of scale. Asset managers with scale will be the ones who can obtain access to attractive investments for their participants. Scale also drives down costs, while increasing net returns. More alpha? Or more beta? Will the new pension contract drive more active or more passive management? The jury is still out on that.

We are used to talking about coverage ratios, indexations, and discounts. In the future we will become accustomed to a new vocabulary: one of transparency. Transparency applies to risk behavior, return allocation methodologies applied, the investment strategy that an asset manager has chosen, and ultimately the actual return for the participant. "Introducing a great deal of complexity in the allocation methodologies will not serve the transparency agenda. In 2026, participants will be able to compare projected returns by age cohort. Even in the absence of choice for individual participants, asset managers need to explain their investment choices in laymen's terms. More frequent and clear communication is needed to take everyone into the new reality of the NPC.

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Jan-Wouter Bloos:
"The pension reform potentially provides a significant opportunity for those active in pension fund buy-outs as well as in the DC and PPI markets. Employer and small sector DB funds in particular may opt for an alternative to conversion to the NPC. These funds combined represent an addressable market of around 80 billion euros of assets under management."

> "The pension reform basically forces a moment of choice on the pension funds. Funds with a DB scheme will not necessarily opt for NPC," stresses Jan-Wouter Bloos Partner Investment Management & Pensions - Consulting.

The improved DC+ scheme as well as a PPI might be attractive alternatives, especially for employers and smaller sector funds. Lower cost and (governance) complexity speak for both. In our view, the pension agreement will accelerate the current trend of fund liquidation. The liquidating funds with a coverage ratio of well above 105% might be attractive targets for buy-outs. Admittedly, few of these funds remain. We have previously (2019) estimated that approx. 4 to 6 billion euros in assets will come to the market over the next five years.

"With pension reform, this number seems like a serious understatement. Employer and smaller sector funds hold approx. 50 billion euros. If we include funds holding up to 4 billion euros in assets under management, it amounts to almost 80 billion euros. A sizable addressable market for pension insurers to get their hands on."

The 10% lumpsum payout at retirement may present another opportunity for asset managers. A general concern is that that pensioners may use it to buy luxury products. However, research suggests that people will act more responsibly and consider using the payout for, e.g., a mortgage down payment.

"But when one does that, the capital remains stuck, like it was in the pension fund in the first place. Asset managers could develop investment propositions with a similar risk-return profile as pension funds, but with the flexibility to withdraw money when needed."

The average participant lumpsum amounts to 15-20 thousand euros.
If approx. 60% of retirees opt for this one-off payout, as the Netspar thinktank suggests, annual available assets are in the range of 1.4 billion euros.

Apart from the lumpsum, we are less hopeful about opportunities for investment managers in the retail domain. Above all, the pension reform is presented as an increased chance of a higher payout on retirement. It is essentially a trade-off between certainty of a lower payout and the uncertainty of a possibly higher payout. This is hardly fertile ground for selling additional pension savings/investment products."

But the reality is that for older employees currently in a DC scheme or PPI (40-50 years old and above – not an insignificant group) will not be compensated by a flat premium build-up in the future. Those in middle age will need to act to preserve their current pension ambitions.

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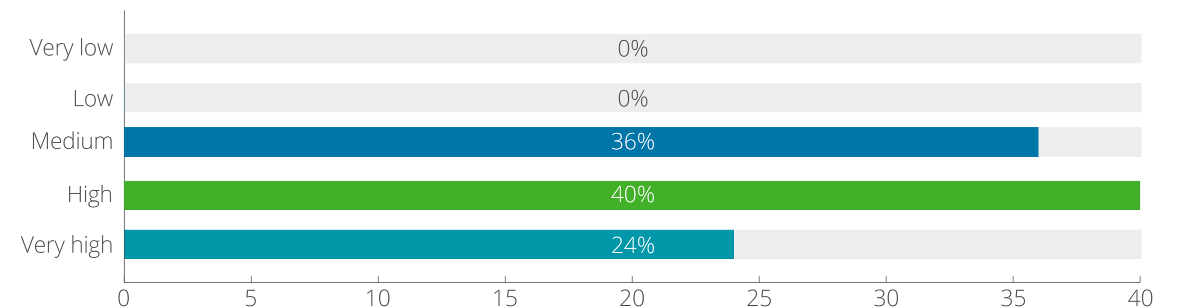
To obtain a sense of the perceived impact of the pension reforms in the sector, we have conducted a survey among 29 asset managers. The anticipated impact on investments is most pronounced. Almost two-thirds of respondents, irrespective of the type of asset manager, perceive the pension contract as having a high (or very high) impact on investment risk, strategy and transparency.

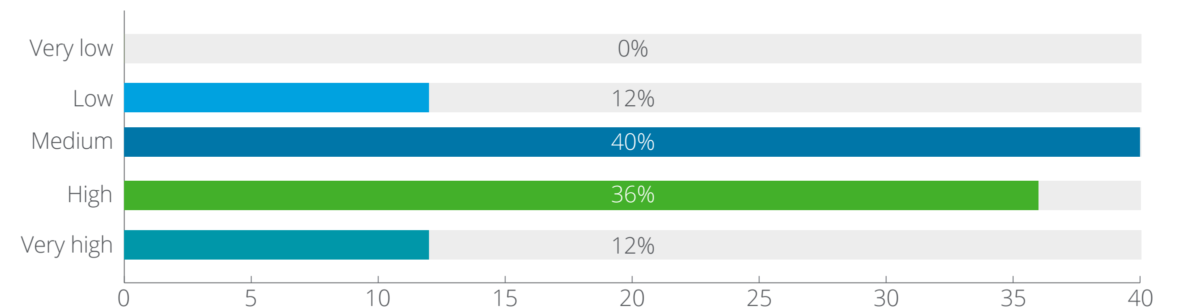
None of the asset managers felt the impact was low or negligible. Respondents have more diverging views of the market opportunity. A small majority regards the pension review as a commercial chance in the institutional and retail investment market . Perhaps not surprisingly, this group is almost entirely made up of insurance embedded and independent asset managers (as opposed to pension fund owned captive asset managers).

The pension agreement is far more than a ripple in the pond for asset managers. It will require executive attention and will feature clearly on the change calendar of investment managers in the coming years.

Investments | Impact on investment risk, strategy and transparency



Market | New opportunities in the institutional and retail investment market



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