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Studying Abroad – European Pension Plan Lessons

By: Frank Goasguen & Simon Segall

European **pension** funds face challenges similar to those facing Canadian plans, although so far European **legislators**, regulators, and courts have not imposed the kinds of surplus ownership and contribution holiday rules that have had such an impact on Canadian **Defined Benefit plans**. Nevertheless, developments in Europe may help Canadian plan sponsors find their way to a reasonable resolution of their current problems.

As in Canada, the **pension** systems in European countries consist of three pillars:

- State-provided systems
- Employment-related plans
- Individual **retirement** savings

Relative reliance on each of these pillars varies from country to country across the continent. For example, the state system in Switzerland targets a pension of about 30 per cent of final salary, while the state system in Italy targets an 80 per cent replacement ratio. Combine the Italian state system's high replacement ratio with a high proportion of older workers and it is not surprising that Italy's 1st pillar system is in urgent need of reform.

Reforming this state-provided 1st pillar in many European countries will result in more assets flowing into the 2nd and 3rd pillars.

Employment-related Plans

Both DB and Defined Contribution arrangements can be found in Europe. Utilization of these designs varies across countries due to different historical factors and social norms. In several of the Eastern European nations that recently joined the European Union, 100 per cent of employment-related plans are DC. By contrast, 'old Europe' largely favours DB plans.

In total, about €3.3 trillion is invested in European employment pension funds. The largest asset pool is found in the UK, at €1.3 trillion, where major companies tend to have large DB plans. Two relatively small countries, The Netherlands and Switzerland, have large DB assets (€489 billion and €393 billion, respectively) due to their compulsory 2nd pillar pension schemes.

Europeans have roughly €830 billion invested in individual retirement savings. Of this, almost 75 per cent is found in the UK, a result of a favourable tax treatment for personal retirement savings as well as a more equity-oriented culture. Personal savings for retirement are relatively low in Germany and The Netherlands due to strong employment-related systems and less equity-oriented societies, and are also low in Italy and France due to heavy reliance on state systems.

A recent McKinsey & Company Study (The Asset Management Industry in 2010) identifies two key trends in the European pension environment:

- a shift from DB plans to DC plans
- a shift from a relative performance orientation for investments to an outcome orientation

For DB plans, these trends imply either a move to become DC plans or a move to change how the DB plans themselves are managed in order to keep them viable. For DC plans, these trends imply continued growth as well as an evolution towards investment products that meet member and sponsor goals rather than seeking to track market-based benchmarks.

Managing In The New DB Environment

As suggested above, those DB plans that are not contemplating conversion to DC are changing their investment paradigms to ensure their longer term viability. Just as in Canada, accounting rules and valuation regulations have caused DB plan sponsors to face much

higher volatility in their pension expense and balance sheets. As well, just as in Canada, low long bond yields and a historical reliance on market index tracking have exacerbated this problem. The pension funding crisis is not just a Canadian or North American phenomenon!

DB pension plans bear risks as a result of interest rate movements. In recent years, European plans have been trying to manage this risk by investing in long duration bonds, cash flow matching portfolios, interest rate swap overlays, and swaptions. However, these approaches do not address the issue of equity risk and can have some serious consequences for the pension expense as well. Consequently some European pension plans are taking a more holistic approach using liability driven investing (LDI). The challenge for pension trustees and their investment managers in operating an LDI approach is to construct a portfolio that combines two separate sub-portfolios:

- a portion that is used for hedging purposes relative to the liabilities of the plan
- a portion that is used to generate upside potential strong enough to keep the pension expense within reasonable bounds

The upside portfolio can be created by combining uncorrelated returns from both strategic market exposures (beta) and from active management (alpha). To maximize the upside potential, the opportunity sets can be increased in both the alpha and beta exposures. Adding new asset classes such as real estate or commodities, or diversifying within existing asset classes by adding new sub-classes such as high yield bonds, can add to the plan's beta exposure. Alpha can also be enhanced through increased exposure to skill through tactical asset allocation, hedge funds, and other portable alpha sources, as well as through a lowering of investment constraints to allow the use of short strategies, derivatives, and similar instruments.

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