Challenges for Pension Funds

Challenging Environment for Pension Solutions

October 2015

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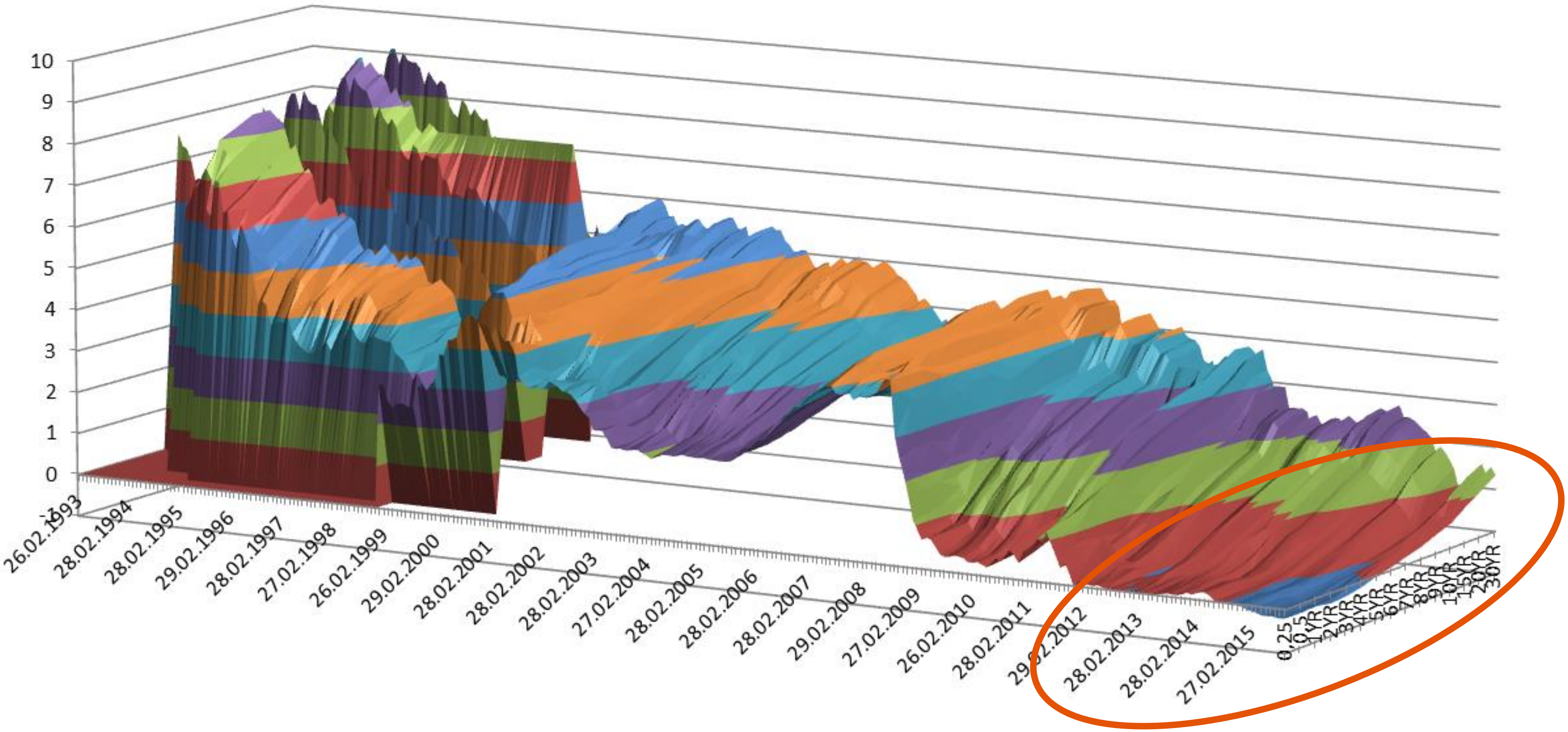
Allianz Global Investors

Understand. Act.

Market Environment is huge challenge for any retirement solution, especially in Europe



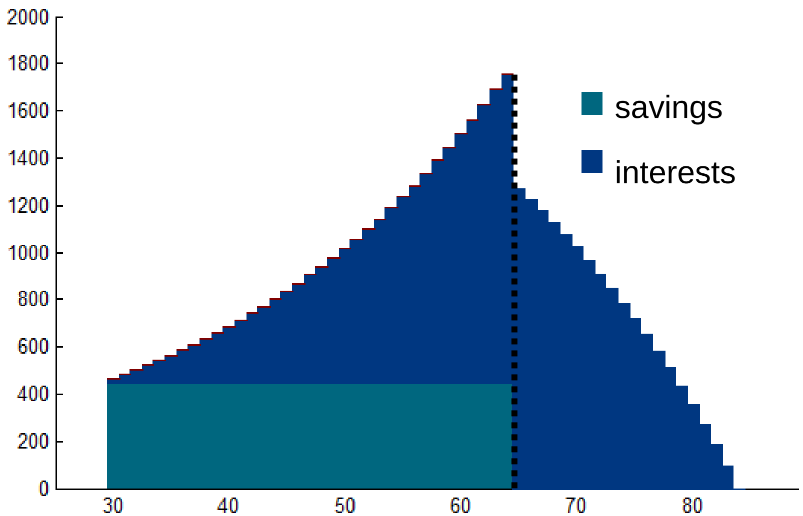
[1] e.g. German Bond Curve between 1993 and 2015.

Guarantees become expensive for pension providers and pensioners
Need for higher contributions in low interest rate environment

- A 30 years old man saves monthly for an old age provision aiming to retire at 65.
- From age 65 a monthly annuity of 2.500 EUR will be paid.
- The annuity will last till age 84 (assuming certain life expectation in Europe)

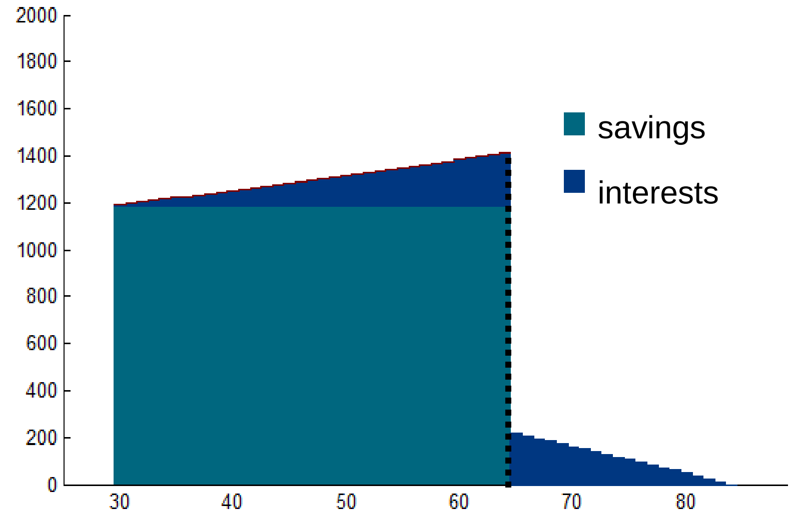
Case 1: Rate of Return of 4% p.a.

- Required saving rate: 446€
- Contribution of interest earned: 67%



Case 2: Rate of Return of 0.5% p.a.

- Required saving rate : 1185€
- Contribution of interest earned: 12%



But also demographic and regulatory changes forces us to rethink traditional approaches

Low Interest Rate Environment

- Current Market Environment and demographic changes are huge challenge for pension funds and insurance companies across Europe.
- Given the extremely low interest rate environment, guarantees became expensive and it needs to be discussed if current guarantee requirements are in the best interest of investors.

Demographic Changes

- People are living longer, such that annuities have to be paid over longer periods of time. An additional challenge if interest rates are low.
- State pension system reduce their benefits. Reduction of annuity exchange rates or prolonged dates for the start of retirement can be observed across different countries.
- Changes from Defined Benefit Schemes to Defined Contribution Schemes transfers the investment risk to the employee.

Regulatory Challenges for Pension Funds

- Pension Funds need to rethink the strategic asset allocation according to their liabilities, taking regulatory requirements into account
- Regulatory requirements might trigger investment behavior. Tighter regulation demands de-risking of investment portfolios and thus induces the exclusion of portfolios with higher expected returns.

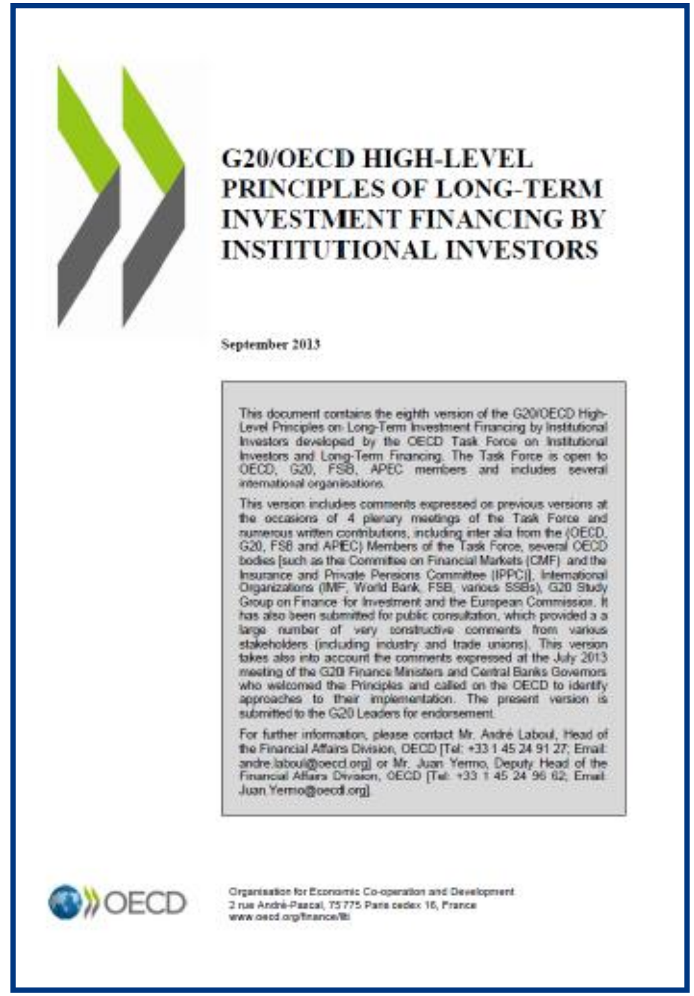
Pension Funds should take a long-term investment perspective

Long-Term Investment Perspective important for society and investment success of pension fund portfolio

- The increasingly short supply of long-term capital since the 2008 financial crisis has profound implications for growth and financial stability.
- It is important to facilitate long-term investment by institutional investors such as pension funds, insurance companies, and sovereign wealth funds.

Why is long-term investment important?

- Patient capital
    - allows Investors to access illiquidity premia,
    - lowers turnover,
    - leads to less pro-cyclical investment strategies and therefore to higher net investment rate of returns and
    - Leads to greater financial stability.
- Engaged capital encourages active voting policies, leading to better corporate governance.
- Long-Term capital provides support for infrastructure development, green growth initiatives, etc., which can lead to sustainable growth.



G20/OECD HIGH-LEVEL PRINCIPLES OF LONG-TERM INVESTMENT FINANCING BY INSTITUTIONAL INVESTORS

September 2013

This document contains the eighth version of the G20/OECD High-Level Principles on Long-Term Investment Financing by Institutional Investors developed by the OECD Task Force on Institutional Investors and Long-Term Financing. The Task Force is open to OECD, G20, FSB, APEC members and includes several international organisations.

This version includes comments expressed on previous versions at the occasions of 4 plenary meetings of the Task Force and numerous written contributions, including inter alia from the (OECD, G20, FSB and APEC) Members of the Task Force, several OECD bodies [such as the Committee on Financial Markets (CMF) and the Insurance and Private Pensions Committee (IPPC)], International Organizations (IMF, World Bank, FSB, various SSBs), G20 Study Group on Finance for Investment and the European Commission. It has also been submitted for public consultation, which provided a a large number of very constructive comments from various stakeholders (including industry and trade unions). This version takes also into account the comments expressed at the July 2013 meeting of the G20 Finance Ministers and Central Banks Governors who welcomed the Principles and called on the OECD to identify approaches to their implementation. The present version is submitted to the G20 Leaders for endorsement.

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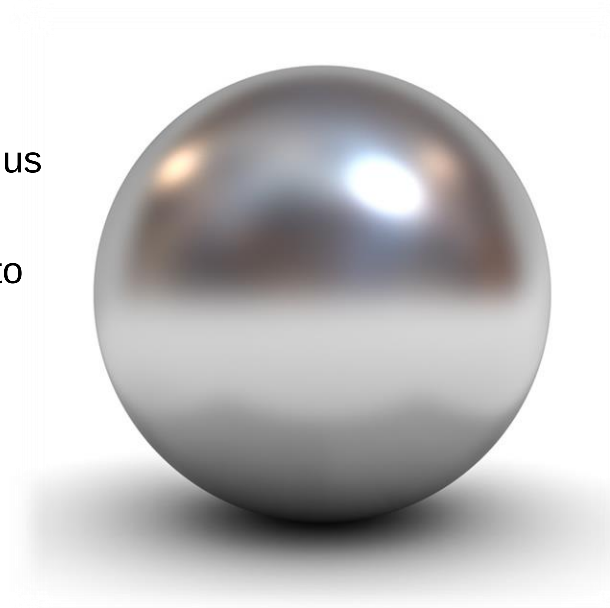
Source: G20/OECD HIGH-LEVEL PRINCIPLES OF LONG-TERM INVESTMENT FINANCING BY INSTITUTIONAL INVESTORS

Regulation will affect asset allocation decisions of Long Term Investors

Investment Behavior under economic view versus regulatory view

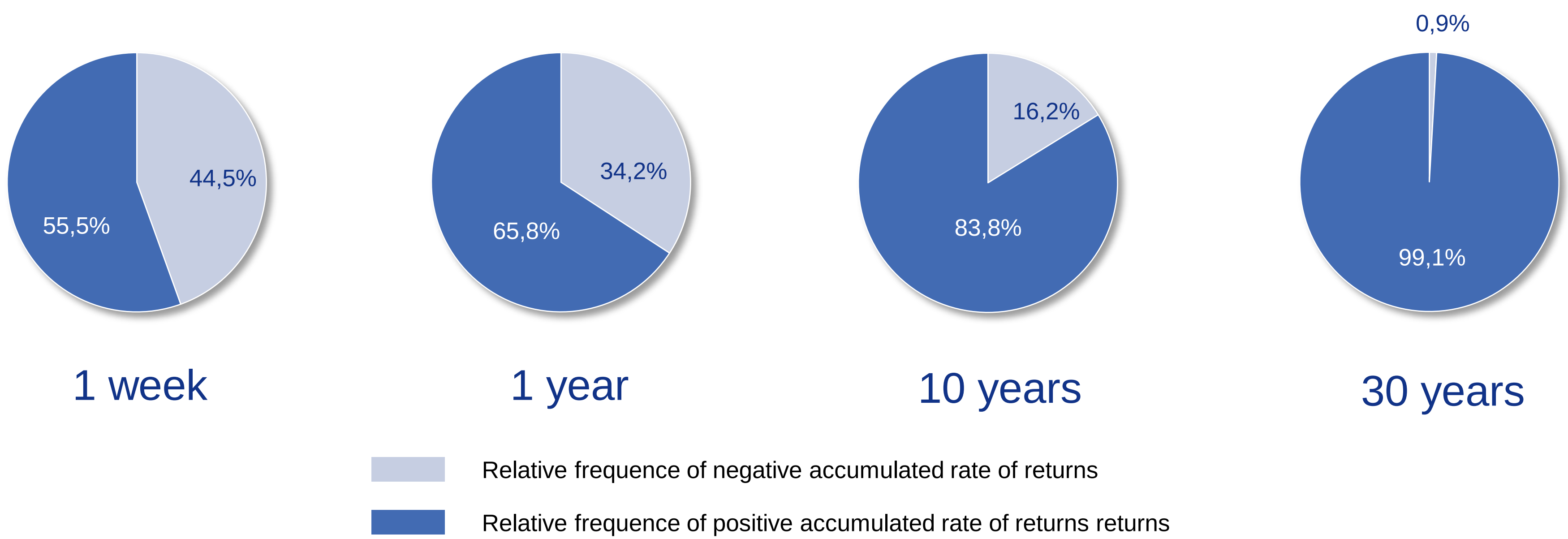
- For some asset classes, the capital charges applied within regulatory requirements do not appear in line with the volatility or downside risk measures of the respective asset classes. This triggers different investment behavior under an economic view compared to the regulatory view
- Some guidelines might provide an incentive to invest especially in a matching portfolio for the liabilities.
- Tighter regulation demands the de-risking of investment portfolios and thus induces the exclusion of portfolios with higher expected returns.
- Some regulatory rules could reduce the interest of pension investments to have a "long-term" investment horizon



Specifications of required amount of solvency capital have a significant impact on the relative attractiveness of asset classes

- Risk Charges for equity and alternative investments imply (compared to traditional asset portfolios) a need to de-risk pension investment portfolios - and with that to invest in less return-generating asset classes
- Private Equity (and also Infrastructure) appears attractive compared to other equity classes. Real Estate and Hedge Funds appear unattractive due to high SCR charges

Probability of Returns from equity investments depending on investment horizon

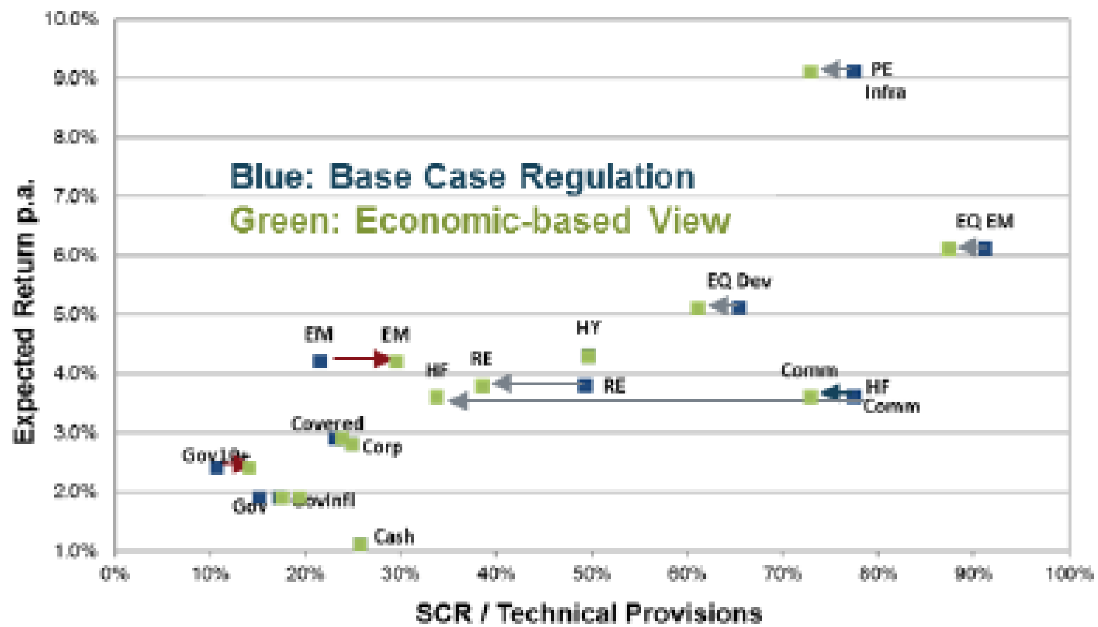


Source: Bloomberg, own calculations, Time horizon 1897- 20.05.2015; Index: Dow Jones Industrial

Diversification plays an important role for the choice of asset allocation

- Alternatives are important for a long term investment horizon.
- Regulatory treatment often difficult and not in favor of alternative investments. From an ALM standpoint this can reduce the set of available asset classes and consequently the diversification effects significantly.
- When allowing for the diversification effects of alternative asset classes (even under very conservative assumptions) one gets broadly diversified portfolios also including Hedge Funds and Real Estate

Economic View (all assets in one asset class)



100% of portfolio in one asset class; base case regulation vs. economic-based view

Questions for Discussions

- Do high guarantee levels in certain old age provision solutions help or hurt for the investment result of the pensioner?
- Do we need more flexibility for contributions into old age provision solutions depending on interest rate environment?
- Do we sufficiently support the development of alternative solutions in the decumulation space, which are able to cope with key challenges of the current market environment?
- Is the regulatory environment for long term investors helpful to achieve investment returns which support a closing of expected pension gaps.

Thank you!

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