

# Managing the Changing Business Environment

Investment and Risk Management Trends in the Dutch Pensions Market

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J.P. Morgan recently hosted the Pensions Roundtable in Amsterdam. The event was organised in response to discussions we had earlier in the year with a number of Dutch pensions funds, who admitted they found it challenging to keep their trustees' understanding of investment risks and considerations current. As well as bringing together key members of the Dutch pension fund industry to share their expertise at a time when all aspects of pensions provision, affordability and regulation are in the political and economic spotlight, the Pensions Roundtable was also designed to serve an educative purpose, helping trustees with the burden of keeping up to date with countless and ever-changing investment matters and the surrounding environmental and regulatory framework within which they operate.

The event attracted attendees from 26 organisations across the Dutch pension fund market, with an agenda focusing on "managing the changing business environment". We took advantage of having assembled our audience by using the opportunity to canvas opinion on a number of subjects. Following the event we then decided to broaden out the survey even further to more of our contacts across the Dutch pension fund industry. We have reproduced the results below, along with some sentiments expressed during the afternoon's discussions. We hope you will be interested to compare your thinking with that of your peer group.

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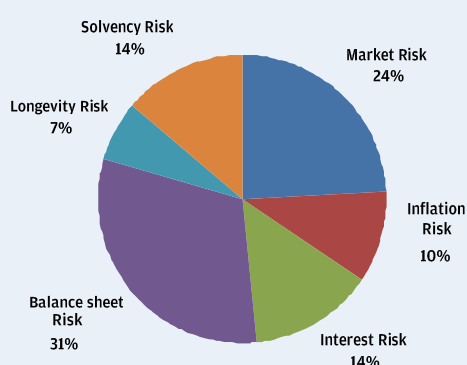
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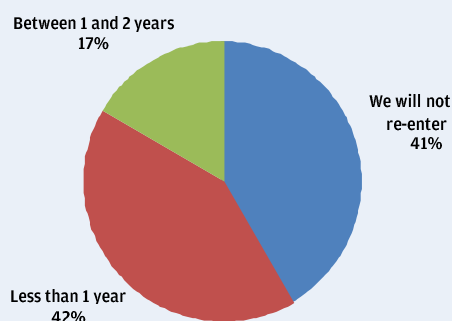
## Risk controls a key priority

In choosing to outsource their pension fund activities or responsibilities – such as investment management, transition management and custody – by far the most important outcome, according to respondents' answers, is improved risk control. Improved returns ranked second, while improved cost control is of least concern. The charts below show the order of priority given to controlling various types of risk.

**Rank the following risks in order of priority you would give to control them, with the most important first:**



**Within what timescale do you envisage re-entering the securities lending market?**



The above focus on risk followed through for transition management in particular. Of the 63% who would outsource the activity to an external transition manager, again risk control is the main influence for such a decision, ranking highest, with expertise following in second place, and cost only picking up a single vote. Operational risk was also ranked highest in a list of factors influencing the choice of transition manager.

The second place runner up was crossing capability, while transparency, fund management capability and trading capability ranked fairly equally next. Once again, cost was the least important consideration. One of the Roundtable speakers acknowledged this when he said that the role of transition management is changing away from total cost to risk management; for example, in highly volatile markets, where pre-and post-transition costs can be dramatically different.

The consensus of opinion was that transition management is not commoditised and there is room for providers to differentiate themselves in the areas of risk management, reporting, overall clarity and interim management. A desire was also expressed that providers offer opinions on the timing of any portfolio transitions – whether a deal should be deferred or not done at all. The ability to do this, however, will depend on whether or not the provider is regulated as an investment adviser. Such a responsibility probably sits more comfortably with investment consultants.

## Dutch pension funds buck European trend for asset reallocation

Interestingly, those survey respondents who are planning a transition, intend to buck the trend identified in the recent Mercer European Asset Allocation Survey, where European pension funds are reducing their equity allocations in the main. Only 32% confessed to be part of this European majority, with the remainder sticking with their equity bets.

## Securities lending activity rallies

The Roundtable was opened with the stark statement that, contrary to popular belief, securities lending is alive and well. The survey results echoed this, showing that recent market turmoil – and the Lehmans collapse in particular – has not dented confidence in securities lending to the extent that might

have been expected. Another Roundtable speaker highlighted the importance of the credit crisis in resetting expectations for lending, with the real focus now being on risk management, which is the impetus for much of the regulatory action we are witnessing at the European Union level. He added that, as a result of such regulatory intervention, securities lending is emerging as a better, much more disciplined business.

Of the 33% of survey respondents who have exited their securities lending programmes in the last 12 to 24 months, over half plan to return, with the majority intending to do so in less than a year. Of the pension funds who currently lend or plan to restart their lending programmes, 14% said they would accept cash collateral, regardless of how it is held and a further 43% are willing to accept cash collateral provided that it is held in a separately managed account, rather than being commingled. The remaining 43% will not accept cash collateral. A clearly important factor behind such decisions is the agent lender's indemnification, with 94% of respondents rating this as "very" or "somewhat" important.

There was agreement and understanding in the audience that, with regard to Lehmans, it was not the failure of contractual agreements which aggravated the situation, but rather the cash collateral reinvestment programmes offered by some lending agents. It rang true with many of the audience that lenders should only accept cash collateral if they have the appropriate level of expertise and, if this expertise is absent, they should hire a consultant or simply look to outsource cash collateral in the same way as they would appoint a cash manager. As one attendee put it, it is not simply a matter of how you manage your cash collateral, and what you do with it – it is not simply that cash collateral is bad and non-cash collateral is good.

Our survey results represent the views of managers of more than 40 pension funds with a range of asset values from EUR 270 million to over EUR 15 billion.

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The general sway of opinion was that participants of securities lending programmes welcome the opportunity to customise their programmes as regards cash collateral, risk and indemnification. They would also value a clear breakdown of revenue components – the proportion of revenue attributed to the stock loan itself and that generated by the cash reinvestment. A cautionary note which surfaced during the securities lending discussion was the fact that revenues from securities lending programmes are currently lower than they have been in the recent past, and participants' expectations should be managed accordingly.

A lively panel discussion was prompted with an opening remark echoing Lord Polonius of Shakespeare's Hamlet, that one should neither a lender nor a borrower be. This statement did find supporters in others who felt that pension funds have a lot on their plate right now and reduced returns do not justify the hassle of securities lending. General Counsel, though, was that every securities lending programme has a degree of risk and there is a real need to understand not only your own risk appetite, but that of your counterparties. Most of all, it was felt that, as a lender, you should have an informed view of securities lending – a tick in the box on a page of a custody agreement is not enough.

## Opinion from the birthplace of fiduciary management

Given our location in the birthplace of fiduciary management, we thought it appropriate to test the temperature on fiduciary management. Interestingly, our London Pensions Summit audience this year appeared to be pausing for reflection on the growth in fiduciary management and contemplating how the goals and objectives of the fiduciary manager can be better aligned with that of the pension fund. In the Netherlands, however, it would appear that fiduciary management is maintaining its momentum, with nearly 70% of the view that it will continue to grow.

## In summary

At the end of the afternoon, general feeling seemed to be that the Roundtable had generated some useful discussion on some of the key themes and trends in the Dutch pension fund market.

Overall consensus was that a clear understanding of risk management and control is of paramount importance and a key balancing factor in reviewing return-generating activities. It was clear that, in particular, the management of collateral in any shape or form is an industry theme which would generate further lively debate among the participants.

We intend that the Roundtable event is the first of a series and look forward in our discussions with you to receiving other ideas as to issues and challenges we can approach in a similar way. We look forward to continuing to work with you on anticipating and tackling some of these issues and challenges, and to seeing you at our next Roundtable event.

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