

Analysing the Dutch Pension Fund Market

From a Custodian's Perspective

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Without doubt, 2008-2009 has been one of the most challenging periods for the world economy in the history of modern finance. The crisis struck at the heart of financial markets, and a series of events in the banking sector eventually led to a well-respected bank – Lehman Brothers – filing for bankruptcy, causing an unrivalled market shock.

Like all other participants, Dutch pension funds have been impacted by recent market events. As a consequence, J.P. Morgan has conducted market research to better understand the relationships between Dutch pension funds (particularly mid-sized funds) and their custodians, as well as current key priorities and concerns for these pension funds. The research was undertaken between July and December 2009, coinciding with a Dutch central bank (De Nederlandsche Bank, or DNB) study of pension fund investment policy and a parallel analysis from the Dutch government.¹

J.P. Morgan's research complements both of these pieces in its review of trends and developments in the Dutch pension fund market, together with the potential effects on custody services. The research also aims to create more transparency in the Dutch custody market with regard to custodians' estimated market shares and how custody decisions are taken and appointments made by pension funds. Using a combination of desk research and survey questionnaire methods, the universe that was captured by desk research covers all pension funds in the Netherlands with assets valued above €100 million. Forty mid-sized pension funds were approached for the survey, 80% of which were corporate pension funds.

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TOP THREE AGENDA ITEMS FOR 2010

- Adjust benefits to market changes
- Focus on risk management
- Educate organization, trustees

TOP THREE INDUSTRY ISSUES FOR 2010

- Multi-OPF platform developments
- Plan participant longevity risk
- Active vs. passive management

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Executive Summary

There are both similarities and differences between Dutch pension funds and their counterparts in the UK and United States, based on historical practices and local market conditions. Recent macroeconomic events have produced an overall 'back to basics' approach, with an increased focus on risk management throughout the industry.

Key findings

- The top three priorities for Dutch pension funds in 2010 are reassessment of coverage ratios, enhanced risk management processes, and resource capability planning
- The top three industry issues for 2010 are multi-OPF platform developments, longevity risk, and the active versus passive investment management debate
- Recovery of financial markets is viewed as the greatest challenge to achieving strategic objectives in 2010
- All Dutch pension funds surveyed use third-party professional advisors, with 67% of respondents using them on a regular basis
- 84% do not participate in securities lending, or have recently stopped lending securities
- The 'stickiness' of relationship between Dutch pension funds and their custodians contrasts with the UK and the United States – with, on average, a 14-year relationship existing in the Netherlands, compared with 8 years, on average, in the UK and United States
- The Dutch custody market is highly consolidated with 82% of assets of midsized Dutch pension funds held by two custodian banks
- There is a growing demand for custodians to educate Dutch pension funds and their boards of trustees on risk factors, including custody-related risks, to improve investment strategy and execution

Research Results

Top three agenda items for 2010 and the potential roadblocks

The top three 2010 agenda items highlighted by pension funds who responded to the survey are as follows:

Firstly, given the financial market turmoil, the changes in the pension fund industry, longer life expectancy and the growing burden of the aging population, some pension funds will fully review their scheme benefits in 2010 to adjust them to the changed pensions landscape.

The second agenda item is the focus on an enhanced risk management process to ensure greater control of the investment strategy and its execution.

Third is a review of the continuity, robustness and quality of the internal organisation to ensure it is able to meet the increasing workload and expertise required to manage a pension fund.

In general, the respondents perceive the recovery of financial markets as the greatest challenge to keeping the organisation focused on achieving the top three agenda items. Furthermore, they see a high degree of education required for their board of trustees in order to ensure focus on these three most important issues for the coming year.

Top three industry issues for 2010

As for the top three industry issues pension funds are following, these are multi-OPF platform developments, longevity risk, and the active versus passive investment management debate. Given that 80% of the survey respondents are corporate pension plans it was no surprise that the multi-OPF platform as an industry development would be followed closely – although the indication was that they are just not far enough down the decision-making process to confirm their serious interest. However, the remaining 20% of survey participants have confirmed that they may consider the multi-OPF concept as a serious alternative to their current business model.

Ahead of recovery plans

During 2009 all of the pension funds we spoke to have focused on submitting their recovery plans to the Dutch central bank and this has been one of their top priorities. The majority had dropped below a coverage ratio of 100%. However, due to the beginnings of a significant recovery of the financial markets in 2009, most are now ahead of the recovery plans submitted to the Dutch central bank. Some fear that this development may lead to a decreased focus on risk management by the pension fund board of trustees.

Third-party professional advisors widely used

All pension funds surveyed use third-party professional advisors in one way or another. Of this group, 67% use third party professional advisors on a frequent basis. The remaining 33% use third-party providers on an ad hoc basis for specific projects.

Branch associations

100% of respondents are active members of pension fund branch organisations and over 65% take active guidance from the branch organisations.

Mixed signals on investment strategy due to market turmoil

Around 50% of survey participants have made no changes and will not make any changes to their investment strategy and strategic asset allocation, considering themselves to be long-term investors. Around 40% of the survey participants, however, have lowered their equity weightings as part of a derisking strategy, and will 'rerisk' when the equity markets allow for this. The lower equity weightings have made room for higher weightings of either cash or fixed income securities. The remaining 10% are questioning whether the whole concept of diversification is truly what is required. They are exploring dynamic strategic asset allocation strategies and liability matching return portfolios in the hope of offering different investment

strategies for active and deferred pension plan members, with the aim of optimising the pension liabilities on the balance sheet of the corporate sponsor.

Risk management a top priority

Other changes which have been made by all respondents concern the frequency and scope of risk management and risk reporting processes. Furthermore, action has been taken to limit any 'hidden' risks, such as currency exposure, as well as unforeseen securities lending risks in externally managed investment mandates. The frequency of reporting to both the investment committees and the board of trustees has increased in order to keep all parties informed and educated on the potential risks with regards to the investment strategy. Nearly 100% of the survey participants find it challenging to achieve a sound understanding of investment risks among their trustees.

Vision and strategy on counterparty risk moving in two directions

Given the recent turbulence in the global banking sector, including the default of some major players like Lehman Brothers, DSB, the Dutch retail bank and the bailout of other Dutch banks, the survey asked whether pension funds' vision and strategy with regard to counterparty exposure for derivatives trading, securities lending and cash management had changed. 50% of respondents have indeed changed their vision and strategy in this regard and have enhanced their risk management processes as a result. The remaining 50% have not changed their vision and strategy, indicating that their risk management framework was already robust enough to deal with the recent market events in the banking industry.

Concentration of assets under custody

Consistent with the findings for Dutch pension funds in general, deep historical relationships between midsized Dutch pension funds and just one Netherlands-domiciled custodian continue to exist. Either through a direct relationship with a custodian bank or through an indirect

relationship via an appointed fiduciary manager or investment manager, 82% of the assets of midsized pension funds are in custody with only two custodian banks, creating significant counterparty exposure.

Fiduciary managers have found their way in

Around 40% of the assets under management for midsized Dutch pension funds are managed by fiduciary managers. Of these assets, 38% are managed by one fiduciary manager. The remaining 62% of these assets are shared among seven other fiduciary managers. None of our survey participants has selected a fiduciary manager, and all have indicated that the probability that they will select a fiduciary manager in 1-2 years time is less than 25%.

33% responded that there was zero probability of them appointing a fiduciary manager in this time frame. A majority of the pension funds indicated that they were exploring the multi-OPF model in one way or another, and seemed to have a preference for the multi-OPF model over the fiduciary management model. 85% were either unsure whether the role of fiduciary management will change and play an increasing role for midsized pension funds, or were certain that it would not. A 15% minority believe that fiduciary management will become very important. The main selection criteria for fiduciary managers are the ability to create sustainable long-term performance and a proven track record in client service.

Majority of pension funds appoint custodians directly

70% of the assets of midsized pension funds are with a custodian bank that has been selected directly by the fund. 83% of funds expressed a preference to select the custodian themselves - even when those assets are managed by a fiduciary manager.

No significant changes to the role of custodians

75% of participants consider that the role of a custodian remains unchanged since the recent market turmoil. The other 25% see a

changing role for the custodian, with a requirement that the custodian not only produces their performance measurement and risk management reports, but also actively advises on the contents in order for the pension fund management to better understand what conclusions to draw from the reported information. This 25% are at the smaller end of the midsized pension fund segment and expressed a requirement to overcome the gap in capacity, knowledge and expertise to draw conclusions from these reports by themselves.

Securities lending: a changing Dutch landscape

To the survey question whether the respondents participate in their custodians' securities lending programmes, 84% have responded that either they do not participate in securities lending at all, or they have recently stopped lending securities, due to the Lehman bankruptcy or the ban on short selling, or they have terminated their securities lending programme and will restart once they have implemented new lending guidelines to mitigate and control any undesired risks. The three main reasons for their responses relate to their exposure to recent adverse market events in the securities lending market.

First, some participants have suffered significant collateral shortfall without any proper indemnification policy in place from their securities lending provider when lending fixed income securities and accepting equities as collateral. Some securities lending providers have made their clients whole for this collateral shortfall. This has put pressure on the financial stability of some local custodians with securities lending programmes and some of the survey participants have indicated that they will not reenter such programmes.

The second reason is exposure to securities lending related commingled cash collateral reinvestment vehicles, which has led to significant and unexpected unrealised losses due to investments in instruments that were not well understood in terms of risks.

Some pension funds believe that switching custodians or securities lending provider in the short term is not possible without realising these losses.

The final reason is the unforeseen risk related to allowing an external investment manager to execute securities lending from their investment pools without clear and communicated securities lending guidelines – including the lack of indemnification against any potential collateral shortfall.

Respondents have also indicated that there are many misconceptions harboured by their investment committees and boards of trustees about the role of securities lending in modern capital markets and how to overcome and mitigate the associated risks. Some of them believe securities lending providers should reeducate the market.

Custody: ‘Sticky’ relationships in the Netherlands

In the Netherlands, pension funds may appoint a custodian directly themselves or the custodian can be appointed by their fiduciary manager or investment manager. Therefore, pension funds can have either a direct or indirect relationship with the custodian of their assets. The custodian appointment is not always made public, causing a low degree of transparency in the Dutch custody market. Based on significant market intelligence and dialogues with these pension funds, J.P. Morgan has concluded that, in general, the average number of years that a Dutch pension fund ‘sticks’ with its custodian (contractual relationship) is almost 14 years. If we then take into consideration the asset value of the pension fund, we see the average duration increases to almost 18 years. As a comparison, the length of custodian relationships between US and UK pension plans and their custodians averages 8 years. The historical reason for these lengthy relationships between Dutch pension funds and their custodians is a strong bias toward Netherlands-domiciled custodians. This loyalty tends to endure, even when a Dutch domiciled custodian has been acquired by a US-domiciled global custodian, and the nature and shape of the

Netherlands-domiciled custodian has changed significantly over time.

Furthermore, J.P. Morgan has investigated the probability of Dutch pension funds reviewing their custodian relationships in the shorter term (between July 2009 and December 2009) and the probability of a custodian review in the longer term (one to two years from July 2009). The probability of a review in the shorter term was 3%. This statistic is borne out by a breakdown of the total number of requests for proposal (RFPs) issued in 2009 in Europe. Only 5% were for Dutch pension funds, as opposed to 68% for UK pension funds in the same period. The number of RFPs for US pension funds was double that of the UK. Both UK and US pension funds are reviewing their custody arrangements far more frequently than funds in the Netherlands.

The low incidence of custody reviews in 2009 is due to the focus these funds have had on writing their recovery plans for the Dutch central bank, as well as the need to get a better understanding of the potential risks within custodian relationships (including related activities, such as securities lending and collateral management). The probability of a longer-term custodian review is estimated to be much higher at 31%.

There are four main reasons for this. First, an increasing number of fiduciary manager appointments will undoubtedly lead to subsequent custody reviews. Second, there is increased interest in the multi-OPF platform from corporate pension funds. Although the centralisation of assets with one custodian in future multi-OPF platforms is not an objective in itself, the search for economies of scale in the multi-OPF model may also lead to changes and convergence in the custody relationships of multi-OPF participants. Third, given changes in EU procurement legislation, increased supervision from regulators and increased pressure on the management and board members of Dutch pension funds to meet their fiduciary responsibilities to plan participants, it is expected that historically lengthy custodian relationships will come

under more frequent review in line with other global pension fund markets. Finally, the recent market distress and securities lending relationships between Dutch pension funds and custodians have put the existing relationships under severe pressure leading to pension funds formally reviewing their current custodian relationship.

Conclusion

The research results presented above show some similarities and some differences between Dutch pension funds and their counterparts in the UK or United States. Recent market events have, understandably, led to a ‘back to basics’ trend. For a while in the run-up to the financial crisis, custody relationships and the risks involved in custody and related activities were assumed to meet basic hygiene levels. Now pension funds are renewing their focus in these areas, as custody reviews appear to be on the increase in the future. Furthermore, there seems to be a growing demand for custodians to reach out to the pension fund industry and educate pension funds and their board of trustees on custody-related issues. One very prominent theme is that the custody market will be heavily entrenched in some significant market shifts.

Notes

1. See Beleggingsbeleid pensioenfondsen onder de loep, *DNB Quarterly Review*, December 2009. In autumn 2009, under the responsibility of the Dutch Minister of Social Affairs and Employment, J.P.H. Donner, the Commission for Investment Policy and Risk Management, led by Prof. Dr. J.M.G. Frijns, also performed an analysis of Dutch pension fund investment policy and risk management (see Pensioen: “Onzekere zekerheid”).