FROM DB TO DC AND BEYOND: LESSONS FOR PENSION FUNDS AND SERVICERS FROM EUROPE AND AUSTRALIA

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In the last 20 years, defined contribution (DC) schemes have taken over from defined benefit (DB) schemes as the dominant pension fund structure. In this article, we look at the evolution of the pensions industry in two contrasting markets, the Netherlands and Australia, and explore how these structural changes will affect funds, their members, and their service providers.

Defined benefit (DB) pensions are a dying breed. These employer-sponsored retirement plans, in which employers guarantee a certain level of retirement income for pension-holders, have become increasingly unsustainable due to longer lifespans, shrinking populations and continuing low-interest rates. For many countries, the solution has been to shift to a defined contribution (DC) mode, in which employees shoulder responsibility for their retirement income and make regular contributions to a post-retirement account, often in combination with their employers.

Over the last 20 years, DC assets in the world's seven largest pension markets have grown from 35% to 53% of the total[1]. Much of this expansion has been in North America and Asia Pacific. On the whole, Europe still remains DB-focussed; but this is starting to change, with governmental and regulatory change driving a shift to DB in large markets such as the UK and Germany.

Now the Netherlands – one of the world's largest pension markets, where 94% of assets are housed in DB schemes – is following suit. In this article we look at the evolution of the pensions industry in this market, and look across the globe to Australia as a market which underwent this change decades ago, and where established DC funds are now facing a new set of challenges. How will these structural changes affect funds and their members' requirements? And how might this influence the relationship between pension funds and their service providers?

1 Global Pension Assets Study 2021, Willis Towers Watson's Thinking Ahead Institute, February 2021, https://www.thinkingaheadinstitute.org/research-papers/global-pension-assets-study-2021/

DUTCH PENSION CONTRACT

Faced with the prospect of cuts to pensioner payouts and increased premiums for younger workers, the Netherlands is instituting reforms to bring in a DC-style new pension contract, encourage existing DB plans to transfer to the new contract and stop the launch of fresh DB schemes. The reforms will have a four-year transition period and are scheduled to take full effect from 2027, at the latest[2]

The new rules have three major implications for pension providers and asset managers. The first concerns schemes' investment policies as they seek to deliver renewed asset-liability matching. "Different age groups will have their own lifecycles and risk profiling, with members within a lifecycle able to choose, say, a defensive or offensive profile, "says John Gout, Senior Business Development Manager for BNP Paribas Securities Services in the Netherlands. "How pension funds put the investment, risk and hedging structure against that is an ongoing debate."

Dutch DB schemes historically have a heavy weighting to bonds, in particular government debt. Given the changing needs and preferences of younger scheme participants as well as increasing longevity risk , schemes may need to diversify their allocations away from bonds in order to seek better long-term returns. Of course, they will still be bound by accounting rules, Asset Liability Monitoring (ALM) studies and available liquidity in the private markets. Across the seven largest pension funds markets, allocations to real estate, private equity and infrastructure have grown from 7% to above 26% in the past 20 years[3]. However, in the Netherlands, it still remains at 10%[4].

The second impact is around communication. "The more that pension contracts are defined by lifecycles and profiles, the more individual they become and the more vocal members will be in terms of, for instance, their ESG priorities or interest in digital assets," says Gout.

"Pension funds will need to provide different communication to members on areas such as individual performance, costs, charges, as well as, increasingly ESG and sustainability-related allocations."

John Gout, Senior Business Development Manager, Netherlands, BNP Paribas Securities Services

Increasingly, this may need to be done at the lifecycle and individual member level.

Thirdly, schemes will need to optimise and digitally transform their pension and investment administration to ensure they can support tasks including more granular client, member and regulatory reporting, as well as embrace technological capabilities to service their members through detailed dashboards or apps.

"Today, the bigger pension funds tend to handle the operational administration function in-house," says Gout. "But that comes with significant labour costs, system demands and regulatory pressures. As we move to bespoke DC-based models, these reporting and administrative requirements will increase, and more funds may look to outsource their front-to-back administration model to alleviate these burdens. Outsourcing to specialised administrators with the necessary

2 Dutch pension reform delayed by one year", IPE, May 2021 https://www.ipe.com/news/dutch-pension-reform-delayed-by-one-year/10052708.articletv

3 IPE, as above

4 Willis Towers Watson, as above

skill, scale and expertise could help free up funds' time and resource, and enable them to focus on transitioning to DC-based schemes in the most efficient way while continuing to generate the required returns."

THE NEXT STAGE OF EVOLUTION: THE AUSTRALIA EXPERIENCE

As the Dutch pension industry grapples with the changes ahead, in other markets the DC model is itself in flux. Australia has developed a hugely successful superannuation fund market over the past 20 years, with asset growth of 11.3% per annum[5].

Two generations of Australians have grown up with the DC superannuation fund system. Recently, the industry is facing a new wave of transformational change as superfunds turn their focus to mergers to develop scale, expand investment capabilities and increase efficiencies. 2020 saw significant M & A activity, including the merger of VicSuper and First State Super to create the second largest superfund in Australia, with over AUD 125bn of assets[6].

Traditionally the majority of superfunds have outsourced member administration, fund administration, pricing and custody. But these mergers are creating larger 'mega funds' that have increasingly complex requirements and are starting to insource functions like asset management. This has increased the demand and expectation for support from their service providers, who must deliver the exchange connections and middle-office environments and support more sophisticated instrument coverage, performance measurement, attribution and ESG reporting.

"Whereas 10 years ago the emphasis was predominantly on vanilla instruments and appointing external managers, that paradigm has changed considerably, particularly with private capital and infrastructure investment," says David Pember, Head of Sales and Relationship Management for BNP Paribas Securities Services in Australia.

> "Superfunds are becoming more complex as they move from being an accumulator of assets to looking more like asset managers."

David Pember, Head of Sales, Relationship Management and Marketing, BNP Paribas Securities Services Australia

A major driver for asset accumulation is increasing government-backed consolidation, which has helped to give the mass of relatively small superfunds that exist today the scale needed to operate successfully.

"Australia's regulator has developed a heatmap of superfunds' performance[7], and will stop automatic contributions going into any fund that is negative rated on the heatmap after two years," explains Pember. "Now all the superfunds are scrambling to merge. The operational and scale benefits can translate into improved returns at lower cost. They can insource a lot of the index-type fund management, which reduces costs to members, and access the scale to buy services at lower rates."

SERVICERS' SUPPORTING ROLE

The economic benefits of scale suggest further consolidation may follow in Australia. This makes it more critical than ever that funds ensure a smooth transition – so members are not 'lost' between funds and continue to receive the expected level of service.

"A key risk of these mergers is the transition risk. It is critically important there is no impact to members," says Pember. "Service providers have a key role to play here. They need to demonstrate they have the scale, experience and capabilities to partner with the fund and deliver a risk-free transition and high quality client experience."

Whether transitioning to DC models, or supporting large mergers, service providers also have a key role in helping pension funds to move forward with their complex and evolving needs. Staying on the front foot with any regulatory changes is one priority. Providers can also support pension funds in monitoring their performance, by incorporating ESG criteria into decisions for example, as well as enhancing asset utilisation through efficient securities lending programmes.

HOW BNP PARIBAS SECURITIES SERVICES IS WORKING WITH PENSION AND SUPERANNUATION FUNDS

In Australia, BNP Paribas has been supporting the superannuation industry for over twenty years and has developed into one of the most respected and committed financial institutions. With more than 400 dedicated local staff and AUD 640+ bn assets under custody[8], BNP Paribas offers strong knowledge of local market nuances as well as the evolving regulatory landscape.

In Continental Europe, BNP Paribas Securities Services is one of the three leading custodians and offers a full suite of services to asset managers, insurance companies and pension funds including global custody, depositary services, investment/fund accounting, performance and risk analytics, regulatory and client reporting. We were awarded 'World's Best Sub-Custodian Bank 2020' for the Netherlands by Global Finance.

5 Willis Towers Watson, as above

6 https://www.vicsuper.com.au/marketing-campaigns/merger-update

7 https://www.apra.gov.au/mysuper-product-heatmap

8 Internal BNP Paribas figures as at 30 June, 2021

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