Trying to serve two masters

Dutch industry-wide funds must show their investment skills every year. **Hans Braker** discusses how conflicts with new FTK regulations will arise.

Anyone who ever attempted to serve two masters knows that the risk of conflicts is enormous. Real success is only possible in two cases. The first case is where the two masters have no overlapping interests. The other case is when they have completely aligned interests. Dutch pension funds have a long history of serving multiple masters, with large areas of overlap and not always fully aligned interests. Due to the intensive collaboration between all interested parties, however, pension funds succeeded in getting through difficult times.

Things become different when regulations and legislation stipulate contradicting goals that give opposite incentives. Especially so when a pension fund faces sanctions if one of the goals is not achieved. Dutch industry-wide pension funds will end up in such a dilemma if current legislation is not changed before new FTK requirements will come into effect.

Now what are the reasons for possible conflicts? Let us first consider the two regulations concerned.

One set of rules will be specified by the new Financial Assessment Framework (FTK). The FTK is expected to come into effect either on 1 January 2006 or, if current opposition against that timeframe is successful, on 1 January 2007. Much about the FTK has been written recently. Loosely speaking, under FTK the investment strategy of a pension fund must assure that the risk of underfunding due to market fluctuations will be limited. The main risk factors and the necessary calculations of the pension fund risk tolerance will be specified in detail. Two characteristics of the FTK are important in this discussion:

- the FTK specifies how a pension fund should address investment strategy (not the tactical implementation) in order to fall within FTK risk boundaries;
- a pension fund can adapt its investment strategy to changing market conditions at any time to assure continuing adherence to the boundaries.

A pension fund having high quality procedures is a pension fund that is able to measure the prescribed risks, and will change investment strategy if necessary. As an example, a pension fund may have chosen not to fully match the duration of its liabilities if its “risk budget” under FTK is sufficient (i.e., if the coverage ratio, as a function of the asset mix, is high enough). This can be a proper strategy if interest rates are expected to rise. If, however, at any time during the year interest rates will fall, the pension fund will see its liabilities increase more than its investment portfolio. This means that the risk budget will decrease. In response, the pension fund may decide that it becomes necessary to increase the duration of its portfolio. In the most extreme case, it may choose to fully match its liabilities. This strategic decision will be reflected in a new investment mandate (a new strategic benchmark). Under the new FTK, a pension fund reacting to the market in the above way is deemed to behave very well.

Note that FTK only involves the investment strategy. The actual investment portfolio may be actively managed, trying to outperform this new strategic benchmark. It can also be an index portfolio designed to track the new strategy.

A completely different set of rules is specified by the Exemption Scheme (Vrijstellingsbesluit) for compulsory participation in industry-wide pension funds. For over half a century already, Dutch law makes it possible to declare participation in an industry-wide pension scheme compulsory for all employers (and thus all employees) operating in the same industry. This means that all civil workers have their pensions with ABP, all health workers are with PGGM, and all bakery workers are with the industry-wide pension fund for bakeries. Under the exemption scheme, there are some possibilities for companies to operate their own pension scheme outside of the industry-wide fund. Such a company scheme must satisfy strict exemption rules.

In 1998, a new exemption rule with regard to the investment performance was introduced by law. This rule was motivated by insurance companies' allegations that compulsory schemes did not have an incentive to set up operations in order to maximise returns, minimise cost and optimise client satisfaction. The rule requires a pension fund to achieve a minimum rolling 5-year tactical performance. Loosely stated, the 5-year underperformance with respect to the strategic benchmark (the benchmark determined by the pension fund itself) should not be too large. A statistical measure, the "z-score", is used to determine whether a fund is said to be a "significantly below average" investor. If the fund passes the test, it is either an average or above average investor. Every year, it is verified which of the industry-wide funds pass the test. For every fund that fails, all participating companies are free to leave the fund and set up their own pension arrangements (of a quality that needs to be at least equivalent to that of the industry-wide fund). Therefore, under the z-score exemption law, a pension fund passing the z-score test is deemed to be a sufficiently good investor.

Now where is the contradiction between FTK and z-score? It seems that a pension fund can be doing the right things both for FTK and z-score: setting an investment strategy (benchmark) within FTK boundaries and achieving a sufficient performance on the portfolio, compared to this benchmark. The main problem, apart from some other objections to the z-score methodology, is that the strategic benchmark should be determined only once, prior to the start of the calendar year. Calculation of the z-score is made after the calendar year, by comparing the actual return with the return of the benchmark. A pension fund can change the benchmark only once during the year in case of extreme situations, and only under strict conditions.

It may thus happen that, in order to adhere to FTK regulations, a pension fund changes its strategy (for example, a continuing decline in interest rate forces the fund to more closely match assets and liabilities) but at the same time it is not allowed to change the benchmark that is used for the z-score calculations. After the calendar year, it will turn out that the pension fund did a very good job under FTK. However, the z-score may have any value depending essentially on what interest rates did after the change in strategy. If interest rates rose, the fund will have to show an extremely negative z-score: the actual portfolio return, with longer duration, underperformed the original benchmark. This will happen even if the fund managers actually outperformed the new benchmark. If interest rates fell further, the z-score will be very high even if actual active management did not add value.

The problem is clear: industry-wide pension funds that do a good job under FTK regulations have a large risk of failing the z-score test, even if they actually outperformed their strategic benchmarks. The solution is also clear: the z-score regulations should be made more flexible. This will allow the pension funds to comply with both regulations and show their actual skills on both the strategic and the implementation level.

Hans Braker is an independent consultant and a specialist in performance analysis.

Illustration: the conflict between FTK and z-score