

An even bleaker future for European DB pension plans as the majority of their members retire

- *A toxic mix of ageing demographics, stringent regulation, rising inflation and falling interest rates have severely damaged the affordability of defined benefit pensions.*
- *As their liabilities mature rapidly, their preferred option of an insurance buy-out remains out of reach for the majority of plans.*
- *They are forced to perform a delicate balancing act between dialling up risk to plug their funding deficits, conserving their capital base and generating adequate cash flows.*
- *As ESG is advancing into the core portfolios of pension plans, pension plans are demanding hard evidence on the impact of their investments.*

London, 1 December 2021 – Global stock markets have been flirting with their all-time highs. But it's a harsh story on the ground for most defined benefit (DB) pension plans, according to a new survey, published today by CREATE-Research and Amundi, the largest European asset manager.

The survey involved 152 DB pension plans from 17 European pension markets across both the public and private sectors, collectively managing €2.1 trillion of assets. It sheds light on how pension plans worldwide are juggling with conflicting priorities at a time when asset values are far removed from reality.

DB pension plans find themselves in a Catch-22 situation: they cannot afford to take risks with persistent deficits in a maturing plan, nor can they cut deficits without taking risks. The dramatic fall in interest rates over the past decade has made things worse.

The Covid pandemic has further compounded the problem. Almost half (48%) now report its negative impact on the longer-term financial viability of plans, versus only 6% who report a positive impact. The impact on funding ratios and regular cash flows has been net negative too. Hence, 60% expect to migrate members from DB to defined contribution (DC) plans.

The gold standard of the End Game is out of reach

Private sector DB pension plans have been required by their regulators to implement various options as part of their so-called End Game. This requires them to show how they intend to meet their pension obligations as ever larger cohorts of post-war Baby Boomers enter their golden years in this decade.

On current reckoning, pension plans are forced to rely on two options. The first is run-off: having very secure finances that can pay pensions until the final member leaves (chosen by 41%). The second option is self-sufficiency (30%): a funding position where the plan is unlikely to call upon the sponsor for additional contributions and can produce the required cash flow to pay beneficiaries. These two options rely on a plan's own balance sheet to meet its liabilities without relying on its plan sponsor to continue bearing all the retirement risks. Only 38% of plans have the funding status to do that.

Zero-bound rates have conspired against their two, preferred, insurance-based solutions, widely regarded as the gold standard of the End Game. These involve passing on all pension obligations to an external insurer partially or fully. Only 25% of our respondents are in a position to pursue these options.

According to one survey participant, *“self-sufficiency is not our first choice, it’s our only choice. Low rates are good for economic revival but they have made pensions unaffordable”*.

Professor Amin Rajan of CREATE-Research, who led the project, said: *“The more rates have fallen, the faster pension plans’ liabilities have increased. Rising interest rates will not be enough to reverse this spiral. Pension plans will need far higher returns on their assets or fresh cash injections from their sponsors”*.

Cash flow matching and inflation protection favour real assets

With insurance-based solutions out of reach, pension plans are obliged to take a more innovative approach to asset allocation and strike a balance between three conflicting aims: generating returns to improve the funding ratio, reducing risk relative to liabilities and having rising cash flows as more members retire. They involve dividing their portfolios into three buckets: return-seeking assets, hedging assets and cross-over assets.

Return-seeking assets typically cover equities. The stand-outs among them are global equities (cited by 63% of respondents), EM equities (57%) and European equities (43%). With regard to hedging assets, once again, European and EM fixed income assets are favoured over US assets, which are deemed too expensive.

Cross-over assets are becoming increasingly important. Their equity-like returns and bond-like features aim to provide capital upside for plugging plan deficits, regular income for pension pay-outs and inflation protection for funding benefit indexation. The most favoured asset classes include infrastructure (59%), real estate (56%) and private equity (48%).

Pascal Blanqué, Group Chief Investment Officer at Amundi, added: *“Asset class returns and correlations have become time varying. Going into risky assets is not the best option for some plans, but it is, unfortunately, their only option. This is not how the End Game was meant to be.”*

Manager selection is now influenced by a range of criteria in the topsy-turvy post-pandemic world

As asset allocation in the End Game has become more complex, the criteria used to select external managers have become more varied and fall into three clusters.

The first centres on ESG and broader thematic expertise. Survey respondents cite the capacity for ESG integration (76%) and thematic investing in general (50%) as key capabilities considered when awarding new mandates.

The second cluster centres on capabilities around End Game deliverables (63%), as well as a deep understanding of liability-driven investing and balance sheet management (52%).

The final cluster seeks to survive and thrive in an environment where asset valuations are at all-time highs and where liquidity can evaporate in an instant. This requires an edge in liquidity management

in periods of high volatility according to 49% of respondents; a deep understanding of return drivers while markets are distorted by central bank action (49%) and an edge in tactical asset allocation in response to time-varying asset class correlations (44%).

Early evidence on ESG investing is encouraging

The pandemic has vividly exposed income and social inequalities, driving home one message clearly: sustainable economies that deliver good investment returns need sustainable societies.

As such, the performance of ESG allocations since the market fall in March 2020 has been encouraging to the point where 76% of pension investors surveyed are keen to increase their allocations. Almost two thirds (59%) will increase allocations specifically to the social pillar over the next three years.

Whilst 67% of respondents cite the primary target of their ESG investments as good risk-adjusted long-term returns, they also want to see some tangible evidence that their allocations are delivering meaningful and material impacts on the ground. According to one respondent *“stewardship is about delivering tangible impacts. Hence, we need a clear line of sight between our investments on the one hand and their real-life impacts on the other.”*

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About Amundi

Amundi, the leading European asset manager, ranking among the top 10 global players¹, offers its 100 million clients - retail, institutional and corporate - a complete range of savings and investment solutions in active and passive management, in traditional or real assets.

With its six international investment hubs², financial and extra-financial research capabilities and long-standing commitment to responsible investment, Amundi is a key player in the asset management landscape.

¹ Source: IPE “Top 500 Asset Managers” published in June 2021, based on assets under management as at 31/12/2020

² Boston, Dublin, London, Milan, Paris and Tokyo

Amundi clients benefit from the expertise and advice of 4,800 employees in more than 35 countries. A subsidiary of the Crédit Agricole group and listed on the stock exchange, Amundi currently manages over €1.800 trillion of assets³.

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³ Amundi data as of 30/09/2021