Coverage ratio protection considerations

The Wtp transition is likely the most significant event in Dutch pension history. Maintaining a stable coverage ratio during this transition can be desirable. Our scenario analysis indicates that a 'dual coverage rate protection strategy' is highly effective, whereas other strategies have a more moderate impact.

By *Jordy Hermanns*

The Wtp transition brings significant decisions, changes and challenges. It is important that it is executed efficiently, with minimal financial and operational risks. In this regard, one key factor to consider is the funding ratio at the transition date and in particular the funding ratio at which a pension fund can transition without haircuts. To avoid unexpected (last moment) haircuts, several pension funds are now considering protecting their funding ratio.

Such considerations are important, as there have been periods when funding ratios have fallen sharply. In Q1 2020, funding ratios dropped by approximately 15%, and during the credit crisis, they fell by 50%. If such a drop were to happen close to the transition date, participant confidence would be seriously damaged, social plans would need to be renegotiated, and the transition could be jeopardized.

Considering this, it is understandable that pension funds are exploring methods to temporarily protect the funding ratio. There are several ways to achieve this:

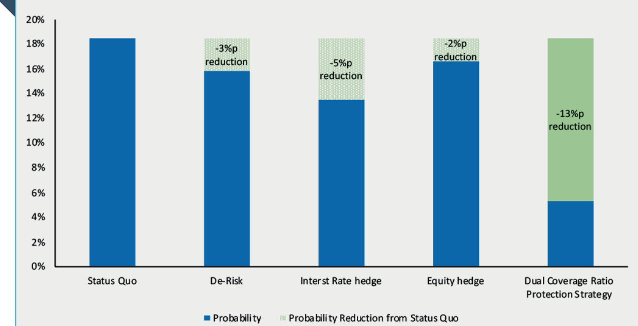
- **De-risk the investment portfolio:** Risky assets can be sold. This change would protect the funding ratio. However, it would also limit upside potential, and de-risking is counter-intuitive as risk-taking is expected to increase post-transition. Also, de-risking might not comply with the general investment policy, taking the long-term return objective of the participants into account.
- **Increase the interest rate hedge:** Many pension funds systematically use an interest rate hedge to stabilize the funding ratio. Increasing the hedge ratio reduces interest rate risk, leading to lower funding rate volatility.
- **Implement an equity protection strategy:** Such a strategy protects against large equity losses while maintaining long-term return potential. In contrast to linear de-risking, or less equity exposure, it allows the strategic asset mix to remain unchanged, making it well-suited for temporarily protecting the funding ratio.

Analysis

We provide an illustration of the funding ratio projections for five investment considerations. The analysis projects the funding ratio using 2,000 stochastic interest rate and equity scenarios based on the Ortec scenario set (2024 Q2). We use the parameters of an average Dutch pension fund as input (as of September 2024). This implies a starting funding ratio of 119% and an initial interest rate hedge of 64%. We consider a minimum entry funding ratio of 105%, at which most pension funds will be able to fill the required buffers, provide some compensation and avoid a cut of pension rights at the transition date. We assume the transition date is two years out. Possible effects of future indexations and/or cuts are not considered. The analysis shows the impact of the various considerations:

- **Consideration 1 - Status quo**
  We analyze the status quo with no changes to the asset allocation and/or risk hedging strategies. The projection shows a 19% probability that the funding ratio falls below the entry funding ratio of 105%. As discussed before, this is an unwanted situation. The risk-return dynamics are unchanged and upside potential remains present. The average funding ratio at the transition date is 121%.
- **Consideration 2 - De-Risking**
  The scenario incorporates a reduction of equity assets by 10%, lowering the risk profile of the asset mix. In this scenario there is a 16% probability that the funding ratio falls below the entry funding ratio. This is a lower risk versus the status quo, but still a significant risk.
- **Consideration 3 - Interest rate hedge**
  In this scenario we consider an increase of the interest rate hedge to 100%. The projection shows that there is a

FIGURE 1: PROBABILITY OF COVERAGE RATIO FALLING BELOW ENTRY FUNDING RATE (105%) AT TRANSITION DATE



Source: Aegon Asset Management. Data as per October 2024.

13% probability that the funding ratio falls below the entry funding ratio. This is a risk reduction versus the status quo, but still a significant risk.

- **Consideration 4 - Equity protection**
  For illustration purposes, we applied a generic option strategy setup with a strike of 90%. This reduces the probability that the funding ratio falls below 105% to 17%. Although lower than in the status quo, this is still a significant risk.

- **Consideration 5 - Dual coverage ratio protection**
  The dual coverage ratio protection strategy combines an interest rate hedge (consideration 3) and the equity protection (consideration 4) in a sophisticated manner. This provides a dual risk hedge versus interest rate and equity risks.

  As desired, the probability that the funding ratio falls below 105% is reduced from 19% in the status quo scenario to 5% with the dual coverage ratio protection. The expected average funding ratio at the transition date is not jeopardized and is 120% (versus 121% in the status quo).

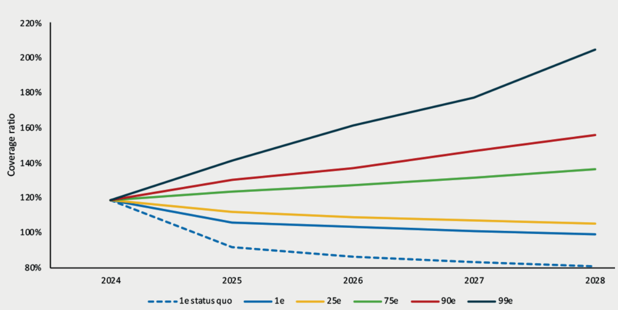
Our analysis shows that especially the dual coverage ratio protection strategy is very efficient to protect the funding ratio during the transition period, whilst at the same time return potential remains present. Interestingly, this strategy provides far superior protection versus the strategies on a standalone basis.

The protection mechanisms

Interest rate hedging could effectively be executed via bespoke mandates or key rate funds. This allows for tailored hedges that match the fund's liabilities. Especially in a situation with volatile interest rates and curve shapes, such tailored strategies are powerful tools to achieve a funding ratio protection goal.

The equity protection strategy can be implemented via bespoke option strategies. Historically, equity investments have been responsible for large drawdowns as well as for return contribution. This makes the asymmetric return profile of this strategy beneficial, with continuous upside potential and a limited downside.

FIGURE 2: COVERAGE RATIO ANALYSIS FOR THE AVERAGE PENSION FUND



Source: Aegon Asset Management. Data as per October 2024.

Additionally, equity protection strategies are customizable, allowing for targeting specific parameters for a limited period. Another advantage is the clear and fixed costs structure, which enables pension fund committees to make a priori informed decisions. This makes it a compelling addition to interest rate hedges for many pension funds during the transition period.

Figure 2 illustrates the projected funding ratio for the 1% most extreme negative scenarios. Under the status quo, the funding ratio declines from 120% to 85%. With the dual coverage ratio protection strategy in place, this decline is mitigated. The funding ratio only falls to 103%, providing a 17pp protection, to the benefit of the participants, as illustrated by the difference between the solid blue- and the dotted blue lines.

The dotted line shows the coverage ratio for status quo consideration (1 percentile of scenarios only). Solid lines are projections for the dual coverage ratio protection consideration (for various percentiles of scenarios).

Conclusion

Pension funds consider strategies to protect the funding ratio during transitions. A dual coverage ratio protection strategy, a combination of interest rate hedges and equity protection strategies, can be used to achieve this. This article demonstrates the potential effects for an average pension fund. Optimal results can be attained through a customized approach. As always, there are risks involved, and pension funds should seek professional advice on this topic. ■

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SUMMARY

The Wtp transition is probably the most significant event in Dutch pension history.

Maintaining a stable coverage ratio during the Wtp transition is desirable.

Interest rate risk management and equity risk management strategies can be considered to protect the coverage ratio during the transition period.

On an individual basis, such strategies are useful but leave some risks.

A dual coverage rate protection strategy, which sophisticatedly combines hedges against both interest rate and equity risks, is highly effective in protecting the coverage ratio.

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