

Press release

Nice, November 5, 2009

## **Pension fund regulation should encourage risk management concludes EDHEC survey**

In a newly-released report by Samuel Sender, Applied Research Manager at EDHEC-Risk, EDHEC has surveyed pension funds, their advisers, their regulators, their fiduciary managers, and their asset managers for their reactions to an EDHEC study entitled “Impact of Regulations on the ALM of European Pension Funds.” The call for reaction elicited 142 non-blank responses and is **the first international survey in which both regulatory constraints and the means of managing them—modern ALM techniques—are assessed jointly.**

Among the key conclusions:

- ❖ Respondents agree that pension funds should take a long-term approach to investing, but they also think that they should manage their short-term constraints; they agree that risk management protects minimum funding ratios better than high funding ratios do, and as such **they believe strongly that regulations should encourage risk management—for instance, by allowing internal models.**
- ❖ Dutch pension funds, which have already implemented risk-based regulation with strict minimum funding ratios, are supportive of the idea that minimum funding ratios should be implemented, as these ratios foster risk management. British pension funds, by contrast, with their chronic underfunding, fear that minimum funding ratios would involve a counterproductive tightening of prudential regulation of pension funds.
- ❖ Respondents also **agree that the funding ratio of the pension fund is not, on its own, a sufficient indicator of the degree of protection afforded pension benefits: the risk to the benefits depends on the combined risk of underfunding and sponsor default.** Respondents argue that the use of modern ALM techniques cannot fully ensure that a pension fund is never underfunded, not only because funding depends on the contribution policy but also because longevity risk has added significantly to liabilities.
- ❖ As a consequence, **a specific measurement of the combined risk of sponsor default and underfunding is required.** Contributions must be raised or assets may be pledged by the sponsor when this combined risk arises.
- ❖ Organisational problems keep pension funds from benefiting from dynamic investment strategies, even though these strategies are viewed with favour by both academics and practitioners: **73.2% of pension funds agree that dynamic strategies ensure that minimum funding constraints are met.**

**This research was produced as part of the “Regulation and Institutional Investment” research chair, sponsored by AXA Investment Managers.**

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“Reactions to an EDHEC Study on the Impact of Regulatory Constraints on the ALM of Pension Funds” can be downloaded by pressing [Ctrl] and clicking on the following link:

[http://docs.edhec-risk.com/mrk/000000/Press/EDHEC\\_Publication\\_Reactions\\_Impact\\_Regulatory\\_Constraints.pdf](http://docs.edhec-risk.com/mrk/000000/Press/EDHEC_Publication_Reactions_Impact_Regulatory_Constraints.pdf)

### **About “Impact of Regulations on the ALM of European Pension Funds”**

The original report on which this Call for Reaction is based, “Impact of Regulations on the ALM of European Pension Funds,” analyses the impact of prudential and accounting constraints on the asset-liability management (ALM) of European pension funds in the Netherlands, the UK, Germany, and Switzerland. In this report, EDHEC put forward the idea that the retirement system would be more stable if regulators were more willing to tolerate short-term risk. The challenge for the regulator is to take a long-term approach to regulation because specific attention should be paid to the long-term nature of pension funds. Traditional pension liabilities have low short-term replicability, and risk-free long-term strategies involve short-term risk. As a consequence, and because of their role in providing very long-term benefits, the increasing focus on the short term is worrying for pension funds. The second key conclusion of the report is that pension funds should build internal models for their risk management strategies. The idea that risk management is best reflected in an internal model is especially relevant for pension funds; after all, no standard formula can capture the diversity of the pension landscape and the variety of protection mechanisms.

**This study was also sponsored by AXA Investment Managers (AXA IM).**

A copy of “Impact of Regulations on the ALM of European Pension Funds” can be downloaded here:

[http://docs.edhec-risk.com/mrk/000000/Press/EDHEC\\_Impact\\_Regulations\\_ALM\\_Euro\\_Pension\\_Funds.pdf](http://docs.edhec-risk.com/mrk/000000/Press/EDHEC_Impact_Regulations_ALM_Euro_Pension_Funds.pdf)

**Contact:**

For further information, please contact:

**Séverine Anjubault**

☎: +33 (0)4 93 18 78 63 - @: [severine.anjubault@edhec-risk.com](mailto:severine.anjubault@edhec-risk.com)

### **About EDHEC**

EDHEC Business School, founded in 1906 and among the select few institutions to have garnered international recognition through the triple crown of EQUIS, AACSB and Association of MBAs accreditations, offers management education designed to meet the needs of companies. For the last four years, as part of its strategy for international excellence, EDHEC Business School has espoused an innovative research policy that takes into account the needs of companies and the market.

The aim of EDHEC-Risk is to produce research that meets the most stringent academic standards and to facilitate corporate use of this research. In partnership with large financial institutions, the research centre brings together 46 researchers and implements six industry-sponsored programmes and ten research chairs focusing on asset allocation and risk management in the traditional and alternative investment universes.

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