BNP PARIBAS

The bank for a changing world

# Governance, cost and sustainable investing:
# Asset owners rethink their strategies

Written by

The Economist Intelligence Unit

# Contents

| | |
|---|---|
| BNP Paribas Introduction | 2 |
| Executive summary | 3 |
| Acknowledgements | 4 |
| I. The forces of change | 5 |
| Managing third party relationships: Our view in Australia | 7 |
| II. New governance models and sourcing decisions | 8 |
| III. Shifting from returns to other drivers | 10 |
| Data challenges: Our view in the Netherlands | 11 |
| IV. Sustainable investing | 13 |
| Alecta Case study | 13 |
| Responsible and green investing: A Nordic view | 14 |
| ESG—The sustainable pillar of risk management | 16 |
| V. Cost as a driver for insourcing asset management and its infrastructure | 17 |
| Our view—The journey to re-insourcing | 18 |
| VI. The reinvention response | 20 |

# Introduction

We are delighted to introduce this asset owner research paper on governance, cost and sustainable investing. The challenges presented by the low yield environment and new regulations are a key topic in our conversations with the industry.

## Scope of the research

We wanted to better understand these changes and share this knowledge with you. This is why we commissioned this paper, which is based on interviews about organisational governance and structure with 23 executives within asset owners (pension funds, insurance companies, and sovereign wealth funds).

## Focus on investment strategies

Asset owners generally report little change in their core strategic objectives, but their underlying investment strategies and structures are clearly being forced to evolve.

Asset owners in general are reappraising their investments with a greater focus on risk versus return. They are investing more heavily into complex asset classes, particularly illiquid asset classes, which makes risk management more complex. Furthermore, asset owners are operating in an environment where they are constrained by transparency and collateral regulations (EMIR), solvency regulations (SII) and pension liabilities.

## Cost control

This environment is driving a second theme—the focus on finding cost efficiencies. Cost in turn is driving changes in the investment process and is one of the drivers for sourcing decisions (managing assets in-house versus using third parties). This in combination with changing investment strategies is leading to a reappraisal of relationships with asset managers and service providers.

## Data complexity

Data was another theme that resonated. The reallocation to illiquid assets is leading to new challenges around data and particularly data normalisation, data consistency and the challenge in understanding risk, return and correlations. Risk management is becoming far more complex and having the right data remains an issue.

## Responsible investing

Finally, and highlighted even further by the United Nations Climate Change Conference (COP21), the focus is on sustainable investing. Asset owners are leading the charge as responsible investors and need support from the investment community, particularly as regards the analytics to measure ESG.

We hope you find this research paper an interesting read and that it might help you validate the changes you are making to your organisation or seeing among your clients.

BNP PARIBAS

# Executive summary

Asset owners are grappling with the forces of regulation and loose monetary policy. Regulators and central bankers have forced asset owners to reconsider how they invest and, crucially, how they manage their tangled risks and operational burdens.

Lower fixed-income returns are pushing some investors into illiquid asset classes. But apart from the largest investors only few are equipped to cope with real estate, infrastructure, and private equity internally. As a result, joint ventures and co-investment structures are proliferating.

Traditional silo-based exposures to bonds and equities are being torn down in favour of factor- and risk-based models. While trade-offs between risk and return have always been a core part of investing, understanding risk has come to feature much more prominently as the shift into more opaque and illiquid asset classes has gathered pace.

Asset owners—particularly trustees in smaller pension funds—may struggle with the complexity of new investment strategies. Environmental, social and corporate governance (ESG) factors are becoming increasingly important, adding further complexity. Yet many organisations see ESG not merely as an issue of reputational risk, but also as a means to improve their management of investment risk and returns.

Regulators are introducing more prescriptive requirements, which are increasing compliance costs sharply. Asset owners, their appointed investment managers and service providers are being pushed further into collateral and cash management while coping with greater regulatory data provision.

All of these investment, data and collateral requirements are guiding strategic sourcing decisions, with data quality the primary issue where multiple partners are involved. According to asset owners, the issue of sharing data between stakeholders and then reporting them correctly and cost-efficiently to regulators has yet to be resolved. In addition, there can be skills gaps, as illiquid asset classes are less familiar to internal staff and traditional custodian services.

Responding to these myriad pressures requires squeezing out costs. However, asset owners stress that operational and administrative sourcing decisions must not be driven by cost alone. Indeed, low cost can be a false economy, particularly when cultural, systems and regulatory requirements are factored in. Rather, asset owners need to balance what they manage in-house, what they outsource, and how these elements come together to deliver on the organisation's overall strategy.

Consolidation is one solution to manage costs and achieve economies of scale. But politically mandated reorganisations thrust upon asset owners are likely to have unintended, unwelcome consequences for investment flexibility.

In all, these are challenging times for asset owners.

# Acknowledgments

The Economist Intelligence Unit (The EIU) bears sole responsibility for the content of this report. The findings and views expressed in the report do not necessarily reflect the views of the sponsor. Paul Burgin was the author of the report and Brian Gardner was the editor. The EIU would like to thank the following individuals (listed alphabetically) for sharing their insights and expertise during the research for this paper:

**Mikael Angberg**, chief investment officer, Första AP-fonden

**Peter Ball**, director, institutional business, Kames Capital

**Greg Cooper**, chief administration officer, Kames Capital

**Peter Curtis**, chief investment officer, AustralianSuper

**Ido de Geus**, head of treasury, PGGM

**Andreas Hallermeier**, sustainability manager, Bayerische Versorgungskammer

**Scott Hartley**, chief executive officer, Sunsuper

**André Heimrich**, chief investment officer, Bayerische Versorgungskammer

**Andreas Hilka**, head of pensions, Europe, Allianz Global Investors

**Chris Hitchen**, chief executive officer, RPMI Railpen

**Tim Jones**, ex-chief executive officer, National Employment Savings Trust

**Michel de Jonge**, policy adviser, public affairs, PGGM

**Henrik Olejasz Larsen**, chief investment officer, Sampension

**Peter Lööw**, head of responsible investment, Alecta

**Johan Magnusson**, chief executive officer, Första AP-fonden

**Paul Moody**, head of product and market intelligence, Aviva Investors

**Laila Mortensen**, chief executive officer, Industriens Pension

**David Neal**, managing director, Future Fund

**Ulrich Ostholt**, chief investment officer, Generali Deutschland

**Bernard Rapp**, deputy head, Germany, Canada Life Deutschland

**Fleur Rieter**, director, pensions, a.s.r.

**Kerrin Rosenberg**, chief executive officer, Cardano UK

**Øyvind Schanke**, chief investment officer, asset strategies, Norges Bank Investment Management

**Johan Stromberg**, director, business development, Nordics, Hermes Investment Management

**Rob Verheul**, chief operating officer, ACTIAM

**Timo Viherkenttä**, chief executive officer, Valtion Eläkerahasto

**Richard Williams**, head of corporate affairs, Pension Protection Fund

# I. The forces of change

Meeting pension promises depends on three factors: collecting adequate contributions; investing them well; and doing so efficiently. The fallout from the financial crisis has weighed heavily on all three.

Asset owners generally report little change in their core strategic objectives, but their underlying investment strategies and structures are being forced to evolve. They must still make real, not merely relative, returns to meet long-dated commitments. Zero interest rate policies make the job harder, yet many pension boards may misunderstand their core problem. It is not the lack of returns: it is all about the risk.

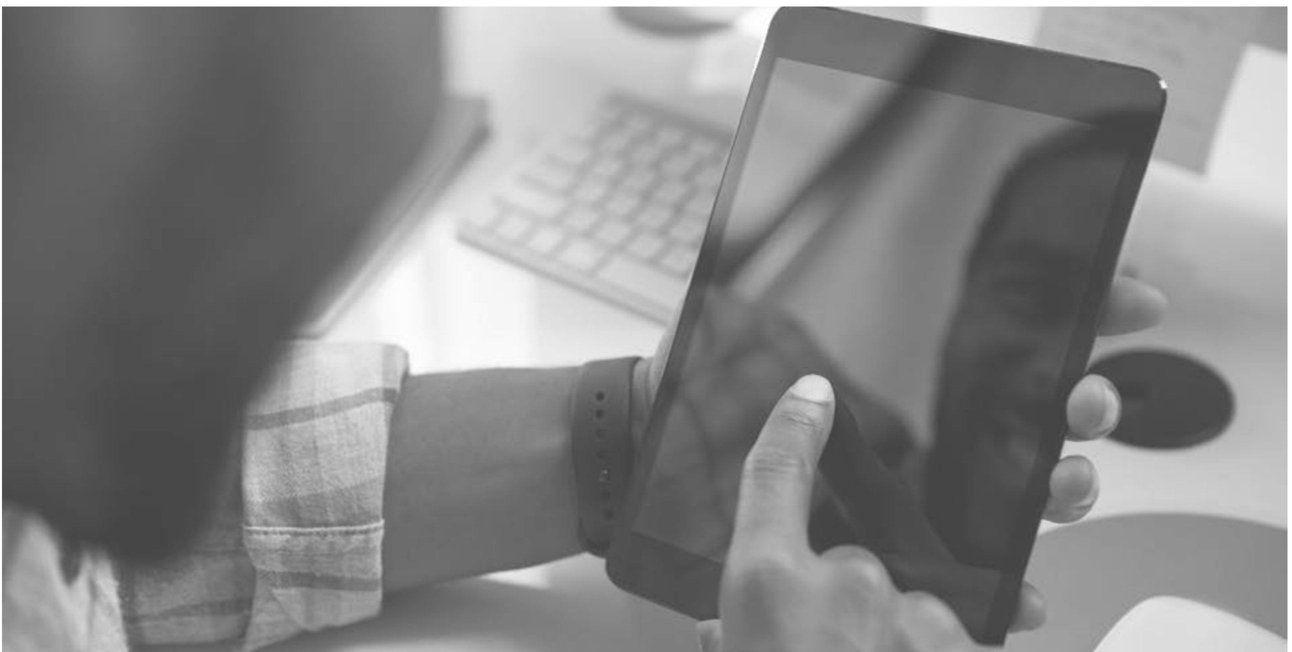
Kerrin Rosenberg, CEO of Cardano UK, a risk and investment management business working with pension funds, believes that most pension trustees hope for the best and prepare for the best. But given the industry's poor record at predicting the future, "hope for the best, prepare for the worst" should be their goal. He believes asset owners should focus on when, not if, a correction occurs—and how much risk they can stomach.

Cash flow effectively dictates that level of risk. Less money coming in and more money going out reduces the level of risk a scheme can take. Closed schemes are in a double bind; payouts are rising but sponsors have fewer links to their ageing ex-employees. Sponsor bankruptcy is a real threat in the UK, in the view of Richard Williams, head of corporate affairs at the UK's backstop Pension Protection Fund. "We don't want the business, it finds us. We cannot control companies going bust."

## Monetary policy

Zero-interest-rate policies are also forcing a redesign in investment products and allocation strategies.

Conservative investment strategies and annual guarantees are a toxic mix, resulting in Germany's low relative occupational Pillar II and private Pillar III scores in Allianz's



**Retirement Income Adequacy**

| | Overall ranking | Overall | Pillar I | Pillar II/III |
|---|---|---|---|---|
| Netherlands | 1 | 7.52 | 6.6 | 9.7 |
| Denmark | 2 | 6.86 | 5.2 | 9.5 |
| Norway | 3 | 6.76 | 6.6 | 6.7 |
| Sweden | 8 | 6.46 | 5 | 7.9 |
| Finland | 11 | 6.16 | 6 | 6.6 |
| Germany | 13 | 5.9 | 6.6 | 5 |
| United Kingdom | 14 | 5.84 | 4.2 | 8 |
| Austria | 35 | 4.5 | 1.4 | 9 |

Source: Allianz
Retirement Income Adequacy Indicator January 2015.

global index covering retirement income adequacy. This assesses countries based on a blend of public and private pension measures and highlights those that may struggle to meet the needs of their future retirees. The Netherlands, Denmark and Norway perform particularly well, with the UK and Germany less well provisioned. Despite the strength of its superannuation system, Australia is pulled down by a low level of government provision.

For German pension schemes, the discount rates applied by many DAX-quoted firms to their schemes are already hurting funding levels. Each percentage-point fall in rates equates to a 20-30% increase in liabilities, says Andreas Hilka, head of pensions, Europe, at Allianz Global Investors. Convincing German employers (and the regulator) that schemes need to take more equity risk is a high hurdle.

While yields are being held down by zero-interest-rate policies, more stringent regulation has increased compliance costs and created new reporting requirements. Although some of the regulatory reforms may contribute to reducing systemic risk, the immediate effect is felt by the squeezed asset owners. For pension schemes attempting to generate alpha returns and reduce risks, finding the optimal balance between return-seeking and index-based portfolios becomes a primary concern. As a result, asset owners are reinventing themselves, restructuring their operating models and reallocating their resources in order to respond to these challenges.

# Managing third party relationships—our view in Australia

**"Asset owners are becoming far better equipped to articulate what they are looking for from their asset managers."**

**David Braga, Head of Australia and New Zealand, BNP Paribas Securities Services**

The drivers of change in Australia—the world's fourth largest pension market—are well known: member demographics, technology and social behaviour, regulation (notably Stronger Super), the financial crisis and (re)insourcing.

Naturally this impacts governance and organisational structures.

Half of Australian superannuation funds say they are using internal resources and up-skilling their teams, and particularly in response to increased regulatory reporting. Two-fifths have opted to use external support, including custodians and consultants.[1]

One clear trend is the (re) insourcing of asset management—two-thirds of superannuation funds expect to bring more asset management and associated operations in-house over the next decade.

The regulator is watching this trend carefully and in 2013 APRA (Australian Prudential Regulation Authority) cautioned:

"There has also been a trend towards more in-house investment management by trustees. This may be entirely appropriate for some trustees, however most are unlikely to have the scale or expertise to effectively undertake in-house investment management."[2]

So how does this environment impact asset owners' third party relationships?

Asset owners are becoming far better equipped to articulate what they are looking for from their asset managers. They have the analytics—developed in-house or in conjunction with third parties—to keep their managers 'honest'. This dynamic is partly driven by those asset owners who are insourcing some mandates and recruiting from the asset management talent pool.

Asset owners have equally realised that the best way to manage their outsourced relationships is by hiring specialist staff from their outsourced service providers. This increase in specialist knowledge within the asset owner is driving the trend to more frequent due diligence on service providers and an ongoing dialogue on all things operational and strategic.

Finally, the current phase of insourcing for asset owners in Australia has seen largely domestic assets taken in-house. The next phase will see asset owners with their own fund managers located and trading offshore. This means that asset owners will need services—custody, administration, trading, middle and back office services—based on a follow the sun model.

David Braga,
Head of Australia and New Zealand, BNP Paribas Securities Services

1 2025: what will the superannuation industry look like in a decade? BNP Paribas Securities Services and the Australian Institute of Superannuation Trustees

2 Helen Rowell, Member Australian Prudential Regulation Authority, **ASFA 2013 Conference Perth, 13 November 2013**

**BNP PARIBAS**

**Decisions to outsource or run investment strategies internally are increasingly about control, expertise and integration.**

# II. New governance models and sourcing decisions

Undoing the traditional asset-class silo mentality is the first step to ensuring sustainability. This opens a path towards more holistic risk management across a range of asset classes. Getting there may require that funds and their trustees seek outside help in understanding how more complex risk-target strategies work. This can mean risk budgeting and appropriate measurement tools while blending active and passive strategies and increasing allocations to more illiquid assets.

## Fewer silos

A greater choice of assets puts pressure on pension boards that may lack the expertise or time to oversee more complicated strategies. Some part-time and "lay" trustees are being nudged to one side and a professional trustee market is emerging.

Some boards are also reorganising how they view their investments. The "White Sheet of Paper Project" at the Dutch Pensioenfonds Zorg en Welzijn (PFZW) reduced 24 asset-class definitions to just four sources of return—interest rates, liquidity, equity and inflation.

Decisions to outsource or run investment strategies internally are increasingly about control, expertise and integration. Rob Verheul, chief operating officer at ACTIAM, a Dutch asset owner and manager, notes that many pension clients would like fewer, but deeper, external manager relationships.

The option to in-house investment strategies largely depends on size. Bigger schemes can attract and retain talent and benefit from realigning the fixed versus variable cost basis of implementing their own strategies.

The Nordic state funds are leading a trend to bring real assets in-house. Some industry-wide schemes are following. Scheme members and regulators want greater transparency on explicit internal costs and the charges of third-party asset managers.

Smaller funds generally have fewer in-house options, partly owing to talent retention, but also as a result of the cost of oversight and regulatory requirements. As they are squeezed by low yields and regulatory compliance costs, such funds may have to opt for fiduciary management if they want to remain independent. Failing this, cost pressures and low returns may lead them to merge or co-operate with larger funds.

**"In 2008, 70-75% of our execution was from algorithms. Today that is closer to 40%,"**

**Øyvind Schanke, CIO of Norges Bank Investment Management**

## Long and short horizons

For those who outsource asset management, principal-agent issues persist. Monitoring can complicate this, according to David Neal, managing director of Australia's Future Fund. Asset owners generally tend to measure performance over six months, which forces their managers to emphasise quarterly or monthly returns in their reporting, rather than long-term potential. Establishing appropriate investment benchmarks can be a crucial part of manager oversight, and it becomes more complicated as asset owners increase their exposure to alternative assets.

Future Fund has adopted "immersed monitoring"—a deeper explanation of what the asset owner requires and constant questioning of external manager decisions. Without it, investment managers tend to obsess about tracking error and then over-diversify lest their best ideas turn into a career risk.

Mr Neal therefore thinks that the internal culture of the asset owner—from recruitment to governance—is particularly important. The fund's board meets at least ten times per year to test its investment team's ideas rather than focus purely on performance data. That mindset rules the relationship between the investment team and mandated managers too. "Sure, there is subjectivity, but it's based on having highly skilled and experienced people on our board and in our management team," admits Mr Neal.

A move into alternatives also means investment horizons must stretch. Första AP-fonden (AP1), one of five buffer funds in the Swedish pension system established to cover the deficit should pension system payouts exceed contributions, has extended its alternative asset horizons from five to ten years, reducing reliance on often meaningless monthly and quarterly reporting in illiquid asset classes. This is a move away from traditional practice, and according to CEO Johan Magnusson, trustee engagement was key to making this happen.

## Operational control

Sovereign wealth funds (SWFs) are also pure growth businesses, typically with an inflation-linked remit and no pension liabilities to match. Timelines are longer, allowing higher exposures to real estate and private equity.

Norges Bank Investment Management runs the world's largest SWF, the Government Pension Fund Global, which is saving for future generations in Norway. It recently reorganised its equity and fixed-income investment structure into three distinct areas—long-term allocation strategies, equity selection strategies and broad asset strategies.

The asset-strategies section comprises the bulk of the fund's assets. The unit's CIO, Øyvind Schanke, highlights that devoting resources to process optimisation adds value, given the fund's size.

Third parties handle global custody, IT infrastructure and elements of data processing. However, trade confirmation, settlement, income and tax handling, corporate actions and valuations have all been insourced with a view to further automation and standardisation.

Internally, 11 people work on implementation issues, including an analytics group specifically looking for broker, algorithm and portfolio-manager trading patterns. The idea is not to replace human managers with black boxes but to boost efficiency and returns.

"In 2008, 70-75% of our execution was from algorithms. Today that is closer to 40%," says Mr Schanke, who adds that the shift to in-house active management reflects the overall size of the Norwegian fund and the resulting index overlaps that can occur as a result. With over US$800bn in assets, different asset managers can end up replicating each other, delivering passive returns with the burden of active management fees.

**"A lot of the data is the same, the templates are already out there. It should be standardised, but that is not always the case"**

**Greg Cooper, chief administration officer, Kames Capital**

# III. Shifting from returns to other drivers

No fund can escape the burden of regulation, even those exempt from specific directives.

## Solvency II

In Europe, the Solvency II Directive is forcing insurance companies to become collateral management experts—or to outsource. It is also affecting investment decisions at insurers that fear a capital-adequacy mismatch.

"Risk capital is also a key driver of investment decisions today," says Ulrich Ostholt, CIO at Generali Deutschland, a German subsidiary of the Italian insurance group.

Under the directive, fixed levels of capital must be set aside against each asset bought in order to protect future promises. In turn, that capital allocation impacts insurance-group balance sheets and liabilities that have to be marked to market. Daily reporting must be fully transparent and standardised, from custodian to asset manager to asset owner, and ultimately to a regulator. But a focus on daily scrutiny can come into conflict with longer-term objectives and investment horizons.

Risk-free assets yield next to nothing, so high-yield credit exposures are increasing—but investment teams must check with the risk department continually to keep group capital ratios on track, adds Mr Ostholt.

## Data compatibility

Collaboratively or individually, asset owners and managers struggle with messy reporting data. Kames Capital, a UK-based asset manager, has worked on providing Solvency II Capital Requirement (SCR) data to asset owners for three years. Having selected a single outsourcing partner to manage this, Greg Cooper, the company's chief administration officer, then discovered that his clients wanted the integration of additional partners, as many already had relationships elsewhere.

"A lot of the data is the same, the templates are already out there. It should be standardised, but that is not always the case," he says.

Legacy systems, calculation methods and processes are not aligned. Asset owners interviewed report wide variations in the quality and consistency of the data they need, either for calculating capital and collateral requirements for clients or for reporting to regulatory bodies.

The EU's Markets in Financial Instruments Directive II (Mifid II) imposes transparency and execution requirements that threaten more of the same, particularly where more than one custody and mid-office supplier is employed.

# Data challenges—our view in the Netherlands

## "Asset owners and their stakeholders are demanding innovative and reliable data warehousing solutions."

**Robert van Kerkhoff, Head of the Netherlands, BNP Paribas Securities Services**

Dutch pension funds—with EUR 1.2 trillion in assets—are among some of the largest and most sophisticated asset owners in the world. They were among the first to move into alternative investments and are now strongly emphasising the need for more responsible investing.

Managing data is a major challenge for asset owners. Data—the building blocks to decision-making—come from a variety of sources—but need to be consistent and normalised (call it transformed) for decision-making.

The immediate data challenges for Dutch pension funds are:

- **the nFTK**—the new financial assessment framework reporting—which requires quarterly reporting on risks and exposure at the level of individual stocks (even where investments are in pooled vehicles)
- more **complex investment strategies** and particularly investments in illiquid assets classes such as real estate and private equity, where data do not yet have the standardisation of traditional asset classes
- **monitoring and measuring carbon exposures**. The Dutch Central Bank has charged the pension funds market with improving the effectiveness of their sustainable investment policies. As such, pension funds are asking their asset managers to address how they will reduce the carbon exposures of their portfolios. The challenge lies in having the right data to measure this

All of these data challenges contribute to data 'bottlenecks' in the value chain (supply • manufacturing • distribution). In response, asset owners and their stakeholders are demanding innovative and reliable data warehousing solutions. Ultimately asset owners need professional partners to transform data into useful information in a consistent and reliable way for all stakeholders in the process.

Robert van Kerkhoff, Head of the Netherlands, BNP Paribas Securities Services

BNP PARIBAS

**"The impact of EMIR will not hurt the asset managers but the members of the schemes."**

**Ido de Geus, head of treasury at PGGM**

## EMIR: The cost of a new financial regulation

The EU's flagship European Markets Infrastructure Regulation (EMIR) could force pension funds to post derivative trade collateral in cash from 2017 (cash variation margin). Even the European Commission recognises that this is likely to cost several billion euros per year.

"The impact of EMIR will not hurt the asset managers but the members of the schemes," says Ido de Geus, head of treasury at PGGM, a Dutch pension fund. The problem is particularly acute in the Netherlands, as schemes have relatively large derivative overlay positions to comply with local risk limitations.

The best solution would allow pensions to post collateral they already own, such as bonds, thus removing transformational risk.

PGGM has responded by tightening its central counterparties standards and barring speculative derivative use. Even so, it took two years to hit a 90-95% accuracy target for daily reporting by counterparties.

## Political reorganisation

Regulatory concerns do not stop at the EU level: political mandates at the national level are a recurring challenge to operational models.

In Denmark, pension providers have had to adapt their business models in response to tighter local rules on intergenerational transfers under the contribution fairness principles laid out by the country's regulator, Finanstilsynet. Industriens Pension, one of Denmark's largest pension funds, and Sampension, a local government provider, have moved from single collective pots to life-cycle products ahead of an explicit intergenerational transfer ban.

## Regulatory overlaps

Regulatory inconsistencies remain unresolved. German insurers will come under Solvency II from January 2016. Pension funds (*Pensionskassen*) and occupational schemes will remain subject to domestic regulation of insurance undertakings (*Anlageverordnung*), with restrictions on assets but no capital requirements—yet. The regulator, BaFin, is unlikely to correct this "dual" market any time soon.

But the thicket of EMIR and IFRS 9 asset accounting rules still means that smaller insurers and schemes are struggling, according to German asset owners interviewed. Lacking the skills and budgets to calculate asset values and book appropriate impairments, they may have to merge to consolidate resources or outsource their entire internal risk-modelling operations.

**Total annual cost of pension scheme arrangements posting variation margin**

| | Cash buffer | Total annual cost |
|---|---|---|
| a) 100 bps ECB rate rise | €204.3bn-255.4bn | €2.3bn-2.9bn |
| b) EBA stress-test | €301.3bn-376.6bn | €3.4bn-4.2bn |
| c) Fed stress-test | €336.3bn-420.3bn | €3.8bn-4.7bn |

Implied cost to pension scheme arrangements in the 28 EU member states of posting cash variation margin under (a) a 100 basis points rate rise, (b) European Banking Authority stress-test conditions, and (c) Federal Reserve stress-test conditions.

Source: European Commission, Baseline report on solutions for the posting of non-cash collateral to central counterparties by pension scheme arrangements.

**"We rely on a wide number of indicators, but are not quite there yet on having a specific number that can measure sustainability."**

**Peter Lööw, head of responsible investment, Alecta.**

# IV. Sustainable investing

Environmental, social and corporate governance (ESG) concerns are of increasing investment importance to asset owners. Regulators are interested too. The Dutch central bank has regularly voiced its opinion about the need for schemes to engage in member dialogue about ESG. Further mandatory requirements and added granularity may nudge more schemes to consider outsourcing their monitoring and reporting commitments.

## An emerging consensus

A consensus is developing around these principles about what ESG is, and the Global Reporting Initiative's guidelines further formalise the process. Yet actual ESG implementation and measurement are far from uniform. Its subjective nature leads to management issues, with widespread outsourcing of stock-filtering and ongoing monitoring.

Many asset owners are signing up to existing ESG standards. US$59trn in global assets are now covered by the United Nation's six Principles for Responsible Investment (UNPRI). There is some consultation beginning around compliance, with the potential to remove signatories that have shown no practice change or improvement outcomes with regard to the UNPRI. This may put pressure on asset owners to get relevant data, measure ESG performance and

## Case study: Alecta

Sweden-based Alecta, an occupational pensions specialist, introduced its first exclusion-based ethical policy in 1998. As a heavy index investor, breaches were inevitable. Alecta switched to a conviction-driven investment strategy in 2004, focusing its equity exposure on 100 stocks, all selected in-house. The environmental, social and corporate governance (ESG) process remains subjective, focused on soft measures such as management quality and governance.

"We rely on a wide number of indicators, but are not quite there yet on having a specific number that can measure sustainability," admits Peter Lööw, head of responsible investment.

The next big step is expanding ESG policies for direct real estate. Alecta has started with a simple approach—electricity consumption is easily measured and easily reduced. Mr Lööw wants to do more on the impact of property development. "We want to be more aware of the materials and the transportation, but we have not really decided on how to approach it yet," he says.

# Responsible and green investing—a Nordic view

**“It is evident that responsible investing is no longer considered just a requirement but a necessary means to manage risk in the region.”**

**Anne-Sofie Strandberg, Head of Business Development, Nordic region**

The world is celebrating the adoption of an historical global agreement on climate change made during the COP21 Paris climate change conference.

The Nordic region has long been considered progressive in its values regarding the environment and society and this is gathering momentum.

Recently the five Swedish Buffer funds—the AP funds—have announced that they will coordinate the way they report the carbon footprints of their investment portfolios.

In November 2015, SEB—one of the largest institutional shareholders among the Nordic countries—announced that it will gradually shift away from supporting investments in coal and would not enter into new business with firms with major business in coal mining.

Carbon emissions are a topic for the industry as a whole and most recently the Swedish Investment Fund Association (Fondbolagens Förening) initiated a table discussion with the Finance Minister, Per Bolund.

There is a role for the banking sector to play in responsible investing on two fronts:

- **Creating and issuing green investments**—including in sustainable energy infrastructure
- **Providing the analytics** to support measuring and reporting on climate risks in investment portfolios and the overall impact on financial performance

The search for new ways to finance long-term growth with sustainable and affordable investments is high on the agenda of the majority of Nordic asset owners. It is evident that responsible investing is no longer considered just a requirement but a necessary means to manage risk in the region.

Anne-Sofie Strandberg, Head of Business Development, Nordic Region, BNP Paribas Securities Services

BNP PARIBAS

**To overcome patchy data, the ESG team uses "triangulation" to join dots, using multiple partners and its own analysis.**

monitor their own outcomes.

Sustainable investing has become a focus area for asset owners seeking to ensure that their investments are aligned with the long-term objectives of their funds. Improved risk management has been a key driver for asset owners, in addition to moral and performance-based rationales. Risk measurement, encompassing sustainable practices in addition to the traditional market, credit and liquidity risk practices, is becoming increasingly important.

## Subjective paths

The evidence that ESG adds to returns is growing, say asset owners. But putting an actual value on ESG is still slippery. Subjective analysis typically involves third-party input and data scrubbing, as not all stocks, bond issuers or funds report in the same way.

In the Netherlands, ACTIAM outsources an initial screening of MSCI World Index component stocks before conducting deeper research in-house. This approach is widespread. Initial filtering is generally outsourced, based on standardised criteria covering benchmark universes; filtered names are then whittled down by subjective in-house analysis, with a final "white list" handed to investment teams for security selection.

As a multi-sponsor provider, Germany's Bayerische Versorgungskammer (BVK) has to negotiate an approach that suits various trade unions and an amalgamation of 12 pension funds. The focus is on engagement policies, and although difficult to measure, the task does not need to be resource-intense. BVK has just one internal sustainability manager, with support and implementation delegated to individual asset-class teams. Sustainable fixed-income ratings and voting rights are outsourced.

Sweden's AP1 focuses on resource-efficiency in the companies it holds. To overcome patchy data, the ESG team uses "triangulation" to join dots, using multiple partners and its own analysis. Their load is lightened by a concentrated portfolio of just 70-80 global stocks. The benefits are twofold: analysis can drill down further, and AP1 has a bigger influence as a shareholder on the stocks it holds.

# ESG—the sustainable pillar of risk management

**"Despite the great advances in measuring classic financial risks—market, credit, liquidity—measuring ESG remains a challenge."**

**Madhu Gayer, Head of Investment Reporting and Performance, Asia-Pacific, BNP Paribas Securities Services**

ESG is the most appropriate tool for institutional investors when considering the long-term impact of their investments.

Yet despite the great advances in measuring classic financial risks—market, credit, liquidity—measuring ESG remains a challenge.

ESG risk assessments require metrics that capture and describe ESG factors and apply these across asset classes and investment vehicles. These metrics—based on quantitative and publicly available data—allow for a comprehensive scoring mechanism and rating of companies and of jurisdictions.

However, there is still a lack of consensus as to all the relevant ESG factors.

For example, an Environmental assessment typically looks at carbon footprint. This in itself requires careful consideration of the data points for inclusion, for example:

- **the range of gases covered** (e.g., NOx, SOx)
- **whether $CO_2$ emissions should be considered from a direct and/or indirect perspective**. This is important as activities upstream while not directly generating emissions, contribute to an overall carbon footprint of the investment, thereby potentially understating the true footprint if only direct measurements are included.

Another issue of course is determining the appropriate data sources and managing patchy data.

These challenges make it more difficult to guarantee the independence and objectivity required to analyse and rate ESG-related risks.

Typically the combination of data, independence, coverage and control means that many pension funds cannot tackle these problems in-house. As a result they are seeking comprehensive solutions externally, through specialist providers.

Madhu Gayer, Head of Investment Reporting and Performance, Asia-Pacific, BNP Paribas Securities Services

BNP PARIBAS

> **"AustralianSuper has aspirations to take 35-40% of assets under management in-house, with a cost saving of 10-12 basis points, or around A$200m per year."**
>
> **Peter Curtis, chief investment officer, AustralianSuper**

# V. Cost as a driver for insourcing asset management and its infrastructure

Cost is one driver for insourcing asset management. Others include managing risk and fiduciary oversight. Asset owners interviewed agree that meeting their obligations requires squeezing out costs. They tend to see some benefit in insourcing fixed income. Yields are so low that every basis point off fees helps. But allocations have to be big—or relatively simple—to merit the start-up costs.

Equities are a mixed bag. Asset owners and allocators recognise the cost benefits in outsourced beta strategies in developed markets and appointing external active management expertise in emerging markets. Yet those who prefer concentration-based, developed-market strategies often believe they can do a better job of selection, cost and risk control in-house.

In general, large asset owners tend to:

- in-house larger portfolios and active, high-conviction strategies;
- in-house equity and fixed-income overlay strategies to protect capital or diversify risk;
- outsource index, aggregate and beta-like strategies; and
- outsource specialist active mandates in emerging markets or small caps.

However, the details are far more nuanced.

## Pay scales

Size is good in a competitive market, but it comes with disadvantages. For AustralianSuper, a near A$100bn (US$72bn) superannuation provider, outsourced Australian equity mandates often overlap owing to its sheer size. This leads to index returns with the cost of active management fees.

AustralianSuper asked CEM Benchmarking of Canada to look at its options. The consultancy found that every 10% of assets taken in-house led to a 4-basis-point reduction in costs by removing asset-management profit margins from the equation. The next stage was to look at what asset classes could be taken in-house efficiently, looking at costs, ease of implementation and capacity constraints. Equities, direct property and infrastructure headed the list of likely candidates.

The fund also looked at other organisational issues, deciding eventually that back office was a scale game it was not large enough to play.

The project took 15 months from business case to board approval and implementation. According to CIO Peter Curtis, AustralianSuper has aspirations to take 35-40% of assets under management in-house, with a cost saving of 10-12 basis points, or around A$200m per year.

The Australian equity portfolio has been running for 18 months. Global equities and direct lending are coming online. Fixed income may follow.

"We are now looking at the most effective way of managing our portfolios of government bonds and high grade," says Mr Curtis.

## Outsourcing beta

When the global financial crisis hit, the Investment Transformation Programme at RPMI Railpen, the £21bn (US$31.5bn) British railways pension fund, overhauled a highly

# Our view—the journey to re-insourcing

**"Building in house asset management capabilities forces operational and technology decisions around what to build, what to buy and where to partner."**

**Sid Newby, Head of UK Pension Fund Sales, BNP Paribas Securities Services**

Motivated by the issues discussed in this paper (principal-agent misalignment, achieving cost efficiencies, a desire to access markets directly and build in-house knowledge), asset owners are considering the benefits of bringing elements of asset management in house.

This impacts decisions around front, middle and back office structures.

## Optimising the front office

Building in house asset management capabilities forces operational and technology decisions around what to build, what to buy and where to partner. Platforms for post trade, middle and back office functions are already well established. Clients are now exploring how they optimise their front office activities.

Some larger pension schemes are influencing third party asset managers on what to trade and how to execute. Outsourced dealing desks—where specialist dealers leverage established networks of counterparties and their connections to execution venues and sources of liquidity—are of growing interest. In this way, asset owners are able to focus on asset allocation and investment decisions rather than trading.

## The investment office

Normalising and correlating risk and performance across asset classes—made even more challenging with pooled investments and risk themed strategies—demands increasingly sophisticated tools and analytics. Furthermore, derivative regulations, LDI/de-risking strategies and illiquid investment have a significiant impact on cash and collateral management. As traditionally back office functions become a front office consideration, the most effective in-house asset management requires building out an 'investment office', with new expertise, systems, governance and processes.

Data provides the platform for the investment office—summarising real time information to analyse the portfolio, monitor exposures, and check compliance—all of which needs to be delivered in a highly visual and dynamic way. Here custodians can play a key role in providing the analytics and support required for the journey to re-insourcing.

Sid Newby,
Head of UK Pension Fund Sales, BNP Paribas Securities Services

BNP PARIBAS

**"We are now looking at the most effective way of managing our portfolios of government bonds and high grade."**

**Peter Curtis, CIO of AustralianSuper.**

outsourced model that had worked until then. Railpen sought to drive down fees, having discovered that real costs were often three times more than explicit charges and that 20% of its assets accounted for two-thirds of its costs.

The solution came from cutting the number of external managers, substituting old strategies for lower-cost versions and in-housing "buy and hold" strategies. "We needed to be more coherent about the way we allocated assets and careful with the amount we were paying away," says CEO Chris Hitchen.

The allocation and investment team has become much more focused on risk premiums and allocates much of its equity exposure to smart beta-type strategies. Global aggregate bond allocations have been chopped; Mr Hitchen claims that his team achieves the exposures they need at far lower costs by purchasing UK gilts as and when needed and holding them to maturity.

According to Mr Hitchen, very simple fixed income can be done in-house for portfolios measured in the tens of millions of pounds. The boundary he places for equities to be managed in-house is much higher at "Probably not less than £1bn".

## A blank slate

Unlike legacy providers, former National Employment Savings Trust (NEST) CEO Tim Jones started with a blank slate. The auto-enrolment, universal-coverage workplace scheme went live in 2012, with zero tolerance for paper-based processes.

"We saw an industry that was tolerating a large volume of paperwork. For our potential scale of half a million micro and small employers, that felt expensive," says Mr Jones.

With total costs eventually capped at 30 basis points, the IT system has to be fully digital. NEST cannot accept paper contribution schedules or cheque payments. Contributions are filed online or by electronic transfer. Web services payroll functionality happens next year.

The front office is digital too. NEST uses a single provider to send aggregated purchase orders daily to its underlying mandated managers. As the member profile matures, the system will automatically reallocate fund units, rather than selling one fund and buying into another, in order to minimise costs.

Some asset owners are looking at other areas to cut their costs. Denmark's Industriens Pension took admin in-house in 2007 and was surprised by the results. "We lowered the cost, and that came as a surprise as we already had low cost with ATP (the public, supplementary labour market pension). It is a focus for us to build things with the lowest manpower", says CEO Laila Mortensen.

Digitisation has also boosted Industriens' communications and customer satisfaction (it is currently placed first in local rankings). Paper-based communication is often ignored, and nearly 40% of scheme members do not read electronic missives sent to their state-run electronic mailboxes. A simple "call us" notice sent by post, email or SMS text message has a greater impact.

## Bucking the trend

When it comes to cost efficiency, there is also a place for a "resource-lite" structure. This runs counter to the trend found among larger asset owners to bring further investment management activities in-house. Finland's Valtion Eläkerahasto (VER) state pension fund has a staff of just 24, with €18bn in assets under management. By relying heavily on index funds and exchange-traded funds (ETFs), VER is able to keep its internal costs down, and internal staff can focus on allocation and oversight.

VER's active allocations are largely via funds. With administration, transacting, IT and back-office outsourced too, reporting and other regulatory burdens tend to fall on its partners and suppliers, not on VER itself, affirms CEO Timo Viherkenttä.

# VI. The reinvention response

All too often asset owners' investment policy reviews jump directly to implementation, ignoring the need for a holistic approach to risk that looks at the whole portfolio, its correlations and combined investment, concentration and operational risks. The issue is most apparent when asset-allocation models expand to include alternative assets. Successfully navigating these issues can result in bigger internal allocation and risk teams for larger funds, or a need for more detailed risk reporting in fiduciary contracts or manager mandates. These myriad drivers are guiding strategic decisions of what to insource, outsource or partner.

## Joint activities

"The pressure to produce returns means we have to ask, could we bring down the cost by doing more stuff ourselves?" says Henrik Olejasz Larsen, CIO of Sampension, a Danish pension fund. He asserts that direct property investment has produced tangible cost benefits over using funds.

Co-investment and joint ventures with other pension funds can reduce costs further. Sampension is part of a consortium that has committed Dkr3.5bn (US$500m) to senior commercial real-estate loans as a substitute for traditional fixed income. AXA Real Estate runs the mandate on better terms than if Sampension had gone it alone, says Mr Larsen.

Co-investment in private equity also has traction. Pension schemes get a larger slice of the investment, but no incremental manager fees on holdings outside of the private equity fund.

## Consolidation

At a broader level, pooling resources may lead to better outcomes. In the Netherlands, the Algemeen Pensioenfonds (APF, the General Pension Fund) aims to allow employer schemes to consolidate resources and still retain control. Insurer a.s.r. is already finalising its launch plans for an arms-length, non-profit APF foundation with an independent board. Initially, a.s.r. will offer administration, reinsurance and investment management to schemes moving over.

"Rings" of defined benefit, collective and defined contribution schemes with similar coverage rates and indexation targets will benefit from economies of scale. There are interesting opportunities for asset pooling. Transferring administration will be the first hurdle. Investment performance and member communication quality will dictate whether the APF's board sticks

> **“We are asking ourselves the question, why change something that seems to be delivering results? We are all above target.”**
> **Mikael Angberg, CIO of AP1.**

with a.s.r. over the longer term. “Communication to employees is our key focus and most valued by our existing corporate clients,” says Fleur Rieter, director of pensions at a.s.r.

Swedish politicians see standardisation and cost caps as a cure for pension sustainability issues. They want to reduce the country’s buffer funds to just three, closing one scheme and rolling the domestic private-equity scheme into another fund. Managers of the AP funds worry that proposed centralised risk-budget setting will oversimplify the system, reducing flexibility and leading to a predominance of passive strategies.

“We are asking ourselves the question, why change something that seems to be delivering results? We are all above target,” says Mikael Angberg, CIO of AP1. The fund returned 14.6% net last year, comfortably above its 5.5% target.

The Australian superannuation market is getting tougher. Members are aggregating their accounts; membership profiles are ageing. Profit-for-member superannuation and retirement business Sunsuper hopes to be a consolidator of choice as member growth slows and industry account numbers decrease.

CEO Scott Hartley believes that cost savings are vital in turning a vicious circle into a virtuous one. According to him, efficient administration will produce bigger benefits than cheap, passive investment strategies. To attract more individual members and improve its potential to become a consolidator of weaker schemes, Sunsuper is investing A$100m in a platform revamp based on enhancing customer experience and economies of scale.

## A path forward

Loose monetary policy and more stringent regulation have become the new normal. This means that the pressure to squeeze out cost is unlikely to let up. But interviewees also worry that developments can focus too heavily on costs, particularly when politicians get involved. When that happens, quality may suffer and reforms tend to have unintended consequences—reducing choice.

While asset owners crave harmonised, low-cost solutions, many also fear harmonisation itself. They want providers to standardise data and IT systems, but without reducing their flexibility to meet their own specific needs. Delivering both while meeting asset owners’ objectives requires deep expertise, either working with trusted partners or developing this in-house.

Adapting to the constraints of the current environment tends to favour larger asset owners. Accordingly, consolidation, co-investing and asset pooling are likely to feature prominently in the coming years. In light of the increasing importance of ESG measures and allocations to alternative asset classes, the need for a wider array of skills is growing.

And regulation will remain a major driver of change for asset owners in the coming years. It is a significant source of cost, a drain on resources and—in some cases—of questionable benefit. But regulation is also a chance to rethink how business is done, to identify what is core to the organisation and what can be better delivered through partnerships.

Asset owners are reorganising their operations, reconsidering their investment strategies and reinventing how they collaborate.

# About BNP Paribas Securities Services' Thought Leadership

Special thanks for this report go to Kate Spencer (Global Marketing Manager, Asset Owners Segment), Mark Schoen (Head of Asset Owner Solutions) and Sid Newby (Head of Pension Fund Sales)

BNP Paribas is committed to creating and sponsoring interesting thought leadership.

Below a selection of some of our most recent publications.

To find out more visit our website http://bit.ly/quintessenceportal or contact kate.spencer@bnpparibas.com

Follow us:

Visit us:

securities.bnpparibas.com

The information contained within this document ('information') is believed to be reliable but BNP Paribas Securities Services does not warrant its completeness or accuracy. Opinions and estimates contained herein constitute BNP Paribas Securities Services' judgment and are subject to change without notice. BNP Paribas Securities Services and its subsidiaries shall not be liable for any errors, omissions or opinions contained within this document. This material is not intended as an offer or solicitation for the purchase or sale of any financial instrument. For the avoidance of doubt, any information contained within this document will not form an agreement between parties. Additional information is available on request.

BNP Paribas Securities Services is incorporated in France as a Partnership Limited by Shares and is authorised and supervised by the European Central Bank (ECB), the ACPR (Autorité de Contrôle Prudentiel et de Résolution) and the AMF (Autorité des Marchés Financiers).

BNP Paribas Securities Services, London branch is authorised by the ACPR, the AMF and the Prudential Regulation Authority and is subject to limited regulation by the Financial Conduct Authority and Prudential Regulation Authority. Details about the extent of our authorisation and regulation by the Prudential Regulation Authority and regulation by the Financial Conduct Authority are available from us on request. BNP Paribas Securities Services, London branch is a member of the London Stock Exchange. BNP Paribas Trust Corporation UK Limited (a wholly owned subsidiary of BNP Paribas Securities Services), incorporated in the UK is authorised and regulated by the Financial Conduct Authority.

In the U.S., BNP Paribas Securities Services is a business line of BNP Paribas which is incorporated in France with limited liability. Services provided under this business line, including the services described in this document, if offered in the U.S., are offered through BNP Paribas, New York Branch (which is duly authorized and licensed by the State of New York Department of Financial Services); if a securities product, through BNP Paribas Securities Corp. or BNP Paribas Prime Brokerage, Inc., each of which is a broker-dealer registered with the Securities and Exchange Commission and a member of SIPC and the Financial Industry Regulatory Authority; or if a futures product through BNP Paribas Securities Corp., a Futures Commission Merchant registered with the Commodities Futures Trading Commission and a member of the National Futures Association.

Printed on recycled paper with vegetable inks – Designed by the graphics department, corporate communications, BNP Paribas Securities Services.

160114C_GCSI_WP_EN

BNP PARIBAS

The bank
for a changing
world