Zentraler Personalausschuss
Central Staff Committee
Le Comité central du Personnel

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Report from the 90th RFPSS Meeting

Summary
To the surprise of the Chairman Dr. Bank (the only independent expert on the Supervisory Board), the Office Management Representatives turned down an adjustment of the Strategic Asset Allocation (SAA) which took into account the low interest environment, thus lowering the probability of reaching the long-term objective for the investment returns, but instead supported initially unfounded and expensive reforms.

Note: this Report covers only the most important agenda points, namely the Strategic Asset Allocation, the Performance Report and issues around the Risk Assurance Function.

The principle of the Strategic Asset Allocation (SAA)

The level of contributions to the defined benefit plans in the Office, such as the old or the new pension schemes, are proposed by an Actuarial Advisory Group (AAG)[1] following a study every two years. The probably **most important assumption** the AAG makes is to determine **the rate of investment returns**[2] which might be achieved over a long investment horizon when the contributions are invested in the capital markets. The level of contributions is set such that together with the anticipated investment returns, they will match the money required for paying the pensions.

Evidently, the assumed rate of investment returns used by the AAG should be somewhat lower or at best the same as the long-term **returns actually achieved** from the invested contributions. Indeed, according to the report, the effective real return of investment[3] was 4.84% since 1985 while the real return of investment assumed by the AAG has been 3.75% since 2006.

There is consensus that in the long run, the returns which can be expected from investment in the stock markets will be higher than the same investment in the bond markets[4]. The reason for that difference is that the former are historically more volatile than the latter. Therefore, it is generally considered to be bad practice to invest money needed in the short term in stocks. If one doesn't, however, need the money until the long-term, the major risk isn't short term volatility, but rather to miss opportunities for considerable returns or even to fail to achieve enough returns to compensate for the effects of inflation. This normally happens through investing too heavily in low volatile investments such as bonds or cash. A good investment strategy is thus aligned to the cash flow needs. Only in 2023 will cash from the RFPSS be needed (net outgoing) for the first time. However, the amount is about 0.1% of the funds' value and even in 2034, the last year covered by the AAG's cash flow projection, the Office will need less money than the planned return from investments[5].

1 CA/53/15, para. 9, 12 and 13
2 CA/53/15 para. 48 to 50
3 Which means in excess of the German consumer price index (CPI)
4 e.g. Domestic Government Bonds, Domestic Corporate Bonds, Domestic Equity, Foreign Equity etc. each represented by an appropriate benchmark – see RFPSS/SB 28/16 pages 60 and 61
5 CA/53/15 para. 86

In view of these cash needs, if one were to follow a similar strategy as implemented for the **Salary Savings Plan (SSP)** for our new colleagues, **all the money would be invested in the stock markets**. The Office, however, follows a different strategy. It invests the money such that the actuarial assumption for the real return of 3.75% is achieved with a high probability while simultaneously minimizing various risks, with a focus on the maintaining the real value of the contributions[6]. When using many asset classes, this is a complex optimisation task - the SAA study - which the RFPSS Supervisory Board (RFPSS-SB) outsources to a specialised company every two or three years, i.e. with a similar frequency to the actuarial evaluations carried out by the AAG.

This procedure allows for reacting to changing economic environments which may require an adaptation of the exact allocations of monies invested in each asset class. Indeed, the exercise is a routine task comparable to using the steering wheel when driving a car.

2016 SAA: How to make a 7b€ Pension Reserve Fund look inadequate

The SAA study[7] completed for the 90th RFPSS-SB meeting called for a reallocation of some 13% of the assets[8], which is more than usual after such an exercise, but doesn't appear excessive when compared to around 40% turnover in the RFPSS in a normal year[9]. With the adapted SAA, the Office might expect to achieve the return target assumed by the AAG, whereas with the current SAA, the Office might expect to miss the target return by some 0.42%.

Nevertheless and very much to the surprise of the Chairman of the RFPSS-SB, Dr. Bank (an independent expert from the University of Innsbruck), **the Office turned down the consultant's proposal** with the votes of PD 4.3 (Ms. Bergot), PD 0.7, (Mr. Del Pozo) and Mr. Pilz the only representative of the Member States[10] present. Ms. Bergot justified their decision by making reference to the next actuarial study[11], the financial study and the change of the funds administrator by the end of 2016. These grounds were indeed surprising since the actuarial study is a biennial exercise and because a SAA-study needs almost a year from the tender to completion, it always delivers the results prior to a following actuarial study; the SAA is a strategic decision by the Supervisory Board which would not normally be expected to substantially change just with the arrival of a new funds administrator[12]; the financial study is IFRS based, which even the Office declares is unrelated to the actuarial methods the AAG uses for proposing the contributions to the pension and social security schemes [13].

Therefore, the Office representative's reasoning appears to be so **ill-founded and misaligned with the interests of the main stake-holders** that one might conclude that it serves instead to realise **another hidden (or at least undisclosed) agenda**.

The statements of the Funds Administrator (FA) were somewhat inconsistent. On the one hand, he argued that the cost for the change to the new SAA involving a 13% shift of assets was 0.14% and therefore not negligible. However, the FA's own reports state that the cost for the yearly 40% turnover is only 0.1%[14]. The FA also stated that the additional risk is hardly acceptable, yet did not provide any figures to support this assertion. An analysis reveals that currently, for a 4.49% return, the probability

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6 See Art. 3(3) RFPSS Regulations
7 RFPSS/SB 28/16
8 RFPSS/SB 28/16 page 40
9 See e.g. CA/60/16 page 9, line "Cash inflow from the sale of RFPSS assets" or Quarterly Reports such as RFPSS/SB 18/16 page 3, line "Portfolio activity"
10 Austrian Patent Office, which is also a beneficiary of the technical cooperation budget.
11 Recommended by the AAG in CA/53/15 page 1, para. 7, to take place as at 31.12.2016
12 It would indeed be very imprudent that the general strategy changed at the arrival of a new Funds Administrator.
13 CA/60/16 page 46 last lines: "Neither the scope of the examined plans nor the valuation methods used by the AAG are congruent with IFRS provisions."
14 See e.g. CA/60/16 page 9, line "Cash inflow from the sale of RFPSS assets" or Quarterly Reports such as RFPSS/SB 18/16 page 3, line "Portfolio activity"

of not maintaining the real value of investments[15] is 12.5%, while for portfolio B (the most balanced adaptation) the corresponding values are 4.91% and 14.0%. Since only returns above the risk-free return contribute to the risk of not maintaining the real value of investments, for every percentage of risk, the RFPSS currently obtains a return of 0.203%[16]. The additional return per percentage point of additional risk by not maintaining the real value of investments for the proposed portfolio B would have been 0.280% (sic.)[17], i.e. considerably higher. It is hard to see how such a considerably **higher return per percentage point of additional risk** is simply dismissed as **hardly acceptable risks** particularly in view of the distant long-term investment horizon.

The Fund Administrator also distributed a presentation[18] given by the International Service for Remunerations and Pensions (IRSP - those who also prepare the data for the salary method). The author had looked into 13 separate pension funds of International Organisations and prepared some statistics concerning the amount of equity investment, thus the asset class, which is considered the major source of risk. With the current SAA, 10 of the 13 International Organisations have a higher exposure to equities than our own RFPSS. If the new SAA had been agreed and implemented, 9 of the 13 International Organisations would still have had a higher equity exposure[19]. Therefore, even with the new SAA, the RFPSS would have an asset allocation safely embedded in the **most prudent** third **among these International Organisations**.

However, probably the most **striking inconsistency** is revealed when the RFPSS is **compared with the SSP** as used by our new colleagues. The name of the *Target Funds*, managed by Fidelity, stems from their claim to pay out 100% cash at their target date while they start with 100% equity when they are first issued. Throughout the time between their first issue and the target date, the volatility of investment is gradually reduced by progressively reallocating investment into fixed income instruments, eventually leading to a 100% cash allocation. A target fund with a 100% cash payout in 2022[20] would have about the same equity exposure as the RFPSS[21]. However, in 2023, the required cash from the RFPSS doesn't exceed 0.1% and even in 2034, the last year covered in the actuarial study, the cash outflow doesn't yet exceed the planned return[22] on investment. Following the logic underlying the *Target Funds*, the RFPSS would currently have an equity exposure of 100% (which wouldn't have to substantially change in the short-term). Therefore, the Office seems to expect that new colleagues will readily accept a much higher risk than the Office does itself, although the risk to the Office can be mutualised over generations.

Further statements made by Ms. Bergot left Staff representatives with the impression that the Office may also try to **influence the investment return assumptions** made by the three independent[23] actuaries of the AAG. If successful, this might lead to pushing for a reduction in the assumed rate of return on investment in the actuarial study, which could consequently **trigger a recommendation by the actuaries either to increase the contributions which the Office could follow and/or lower the benefits**.

Performance Report

The results of the SAA eventually translate into a benchmark. It is the combination of 2% Liquidty, 3%

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15 The criteria mentioned in Art. 3(3) RFPSS Regs.; Remark: This figure reflects only the last year of the simulation. A recovery after the depression isn't considered therein.

16 RFPSS/SB 28/16 page 6: German Inflation 1.17%; page 3: Risk Free Return as reflected in the cash returns: 1.95%; (4.49%-1.95%)/12.5%=0.203

17 RFPSS/SB 28/16 page 42: The additional return for portfolio B amounts to 0.42% and the additional risk of not maintaining the real value of investments amounts to 1.5%, thus 0.42%/1.5%=0.280

18 11th Workshop on Pension in International Organisations; Strategic Asset Allocation: A challenge for pension funds in International Organisations, Jean-Claude Eloundou, Actuary, page 17

19 RFPSS/SB 28/16 page 16: Current equity exposure: 50%; Proposed portfolio B: 58%

20 Interpolated between the Target Funds 2020 and 2025. A Target Funds with a target date 2022 doesn't actually exist.

21 See Presentation to Participants of the Salary Savings Plan, The Hague 26th Feb. 2016; page 17

22 CA/53/15 para. 86

23 See CA/53/15 Summary

Danish Mortage Bonds, 17% Domestic Government Bonds etc.[24], each represented by an appropriate index. It serves as a reference against which the funds management performance is measured. This benchmark should in the long run deliver a return above the AAG's assumed return with high probability.

As in previous years, the benchmark **was again surpassed** by our RFPSS fund managers and we congratulate the whole Fund Administration staff for that. Unfortunately, last year the benchmark itself fell short of the assumed return by the AAG. This shows the importance of selecting an appropriate SAA.

Over the last 20 years, the RFPSS have **delivered returns (6.31%) far above both the benchmark (5.86%) and the long term actuarial assumption (5.42%)**[25].

Mandate for the Risk Assurance Officer (RAO) -

Besides the risk manager who is part of the funds administration team reporting to the Funds Administrator, since 2014 an additional position outside the funds administration was created: the RAO who reports to the RFPSS-SB on risks taken by the RFPSS. This new role was viewed critically by the SR because the exact tasks for the role were not clearly defined at the time of the decision. This year, even the Board of Auditors have issued critical comments[26] on this issue.

It turns out that role definition and task allocation continue to be a **construction site**. Although the principal addressee of the RAO's reports should be the RFPSS-SB, both the role's mandate and code of conduct were drafted by the RAO rather than the SB members. Unlike the name suggests, the Risk Assurance Manager's scope of work is not only to verify whether the figures reported to the RFPSS-SB by the FA are correct, but also to monitor strategic risks. Although several attempts were made to clarify the situation, there remain issues of scope in areas of potential overlap of these two positions. Furthermore the mandate, again only agreed through the votes of the Office's management and the member states, cannot overcome this deficiency[27]. The lack of clear responsibilities is indeed a risk for the RFPSS. Literature suggests that a lack of clear governance is a common source of pronounced under performance[28].

Summary

For the RFPSS, the Office has rejected an increase of the equity exposure to 58% while the participants of our own Salary Savings Plan would have a 100% equity exposure in a comparable situation and the vast majority of International Organisations have an equity exposure in excess of 60%. The Office thus unnecessarily lowers the probability of reaching our long-term objective for the return on investment, thereby deliberately creating a situation that could be used to trigger further major reforms.

The governance in terms of risk monitoring is still unclear through inadequate role clarity, while such governance deficiencies are recognised as often leading to under performance.

Unfortunately, whatever the outcome, it is the staff (and only the staff) who will have to pay the bill.

The Central Staff Committee

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24 RFPSS/SB 28/16 page 40
25 RFPSS/SB 34/16 Rev.1 page 10 and 11
26 CA/20/16 para . 178 to 181
27 RFPSS/SB 40/16
28 Investment Beliefs: A Positive Approach to Institutional Investing, Koedjik and Slager, Palgrave Macmillan 2011, page 10