Dutch pension funds set to retire long-dated hedges

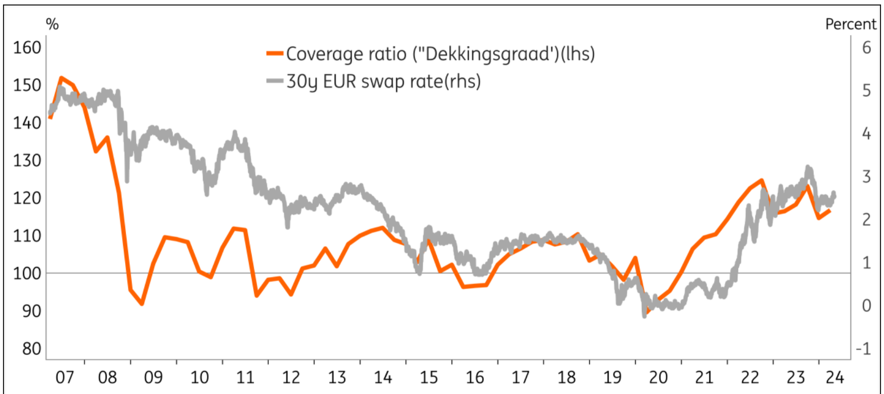
The next big Dutch pension reform is coming, moving most of the system towards a Defined Contributions model over a period of 3 years. We foresee large flows of fixed rate paying in long dates, from 30yr out to 60yrs, as prior fixed rate receivers are unwound. Steepening pressure along the 20-30yr segment is expected as 10-20yr receivers remain in place

This reform changes the very fundamentals of the Dutch pension system

On 1 July 2023 the Wet Toekomst Pensioenen (WTP) came into force, a new law kicking-off a lengthy transition period through to 2028 during which Dutch pension funds must implement fundamental change to the way they work. The reforms dictate that all future pension payments follow a Defined Contributions (DC) scheme. This is a big shift given that 87% of pension fund participants are now on a Defined Benefits (DB) scheme. Pension funds have the choice to run the old and new pension pots in parallel, but a survey by De Nederlandsche Bank (DNB) suggests that pension funds accounting for 97% of total participants will choose to convert the existing pension pot into the new system ("invaren"). Pension funds are currently drafting their transition plans with moves from some already in 2025.

Under the current DB model the future pension payments are fixed and the coverage ratio ("dekkingsgraad") is the key measure to assess a fund's health, which results in active rate risk hedging. The coverage ratio is calculated as the ratio between a fund's assets and the discounted liabilities, the latter having long horizons for younger participants. The discount rates for the promised payments out to 50 years are derived from the EURIBOR 6-month swap curve, which is then extrapolated for liabilities further into the future. Consequently, the coverage ratio can fluctuate strongly with moves in the EURIBOR curve (as shown in the chart below). The pension system currently relies on (ultra) long-term hedges through swaps and swaptions to mitigate excessive volatility. With €1.8tr in assets under management, the footprint in these markets can be significant.

The current system is sensitive to long-term interest rates



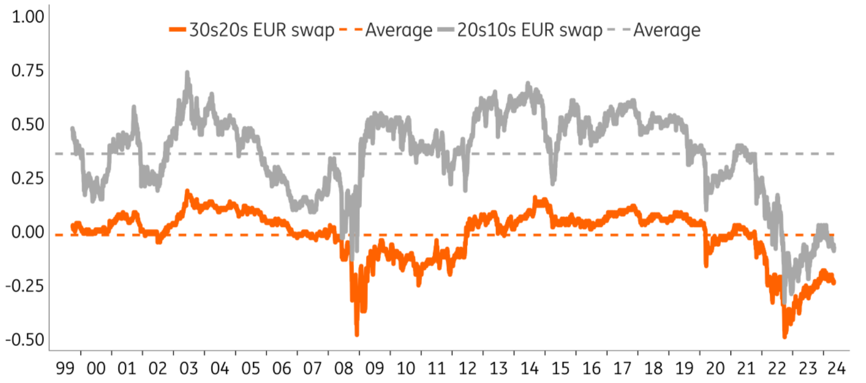
Source: ING, Macrobond

Fewer long-term interest rate hedges needed post-reform

The move to a DC system means that future liabilities are no longer fixed but move along with the value and return of the assets, thereby reducing the need for interest rate hedges. We foresee structurally lower demand for fixed rate receiver swaps with tenors between 30y and 50y after the reform since interest rate hedges will be of less interest to younger participants. In fact, the interest rate hedge for young participants may be almost fully unwound in the present environment of low term premia, which would trigger significant flows.

As the figure below highlights, the current inversion of around 50bp for 20s50 offers little incentive to extend duration (from a non-actuarial perspective).

Negative term premia are disincentives for long-term hedges



Source: ING, Macrobond

For participants closer to retirement there will be a continued requirement for interest rate hedges to mitigate fluctuations in pension payments. After the reforms the hedging preference for older participants could actually show an increase and may even approach 100% of interest rate risk. The new system is more accommodating to such age cohort specific calibrations and thus fixed rate receiver swaps between 10-20y may see increased activity.

Overall the reforms would steepen the back end of the swap curve, but the new pension system gives more flexibility to steer duration dynamically, which could lead to an extension of duration once term risk premia return. Currently low term premia make hedging long-term interest positions unattractive, yet these term premia should normalise in the coming years.

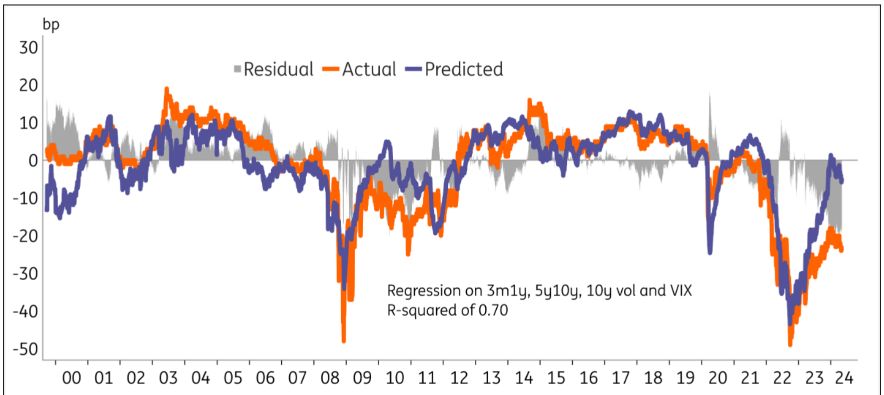
That said, actuarial requirements, where applicable, will ultimately dominate.

Our fair value model suggests significant 20s30s steepening potential

To identify the potential steepening on the back end of the curve we start by looking at the current deviations of 20s30s from fair value. Our regression model includes slopes on the shorter end of the curve, together with 3-month rolling 10y yield volatility and the VIX. These inputs should be exogenous to the hedging strategy of Dutch pension funds on longer tenors.

Since 2023 the deviation from fair value has been significant, and is now close to -20bp, implying potential for a considerable amount of steepening. Going forward we foresee a steepening of curves more broadly and, together with the pension reforms, the 20s30s slope could see a move into positive territory of around 10bp, in line with the level of elevated values in the past.

A fair value model of 20s30s suggests significant steepening potential

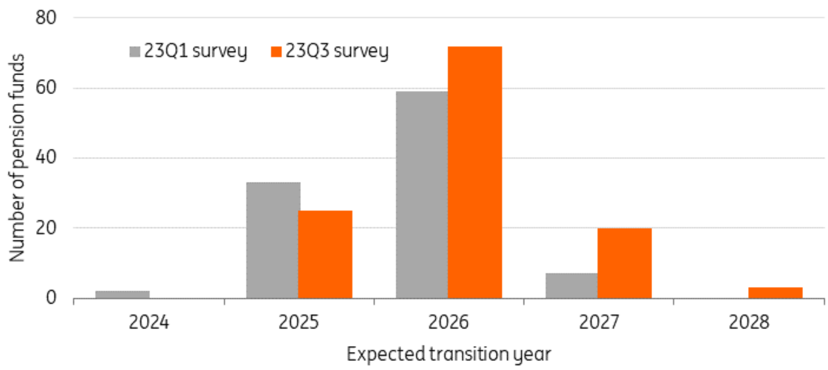


Source: ING, Macrobond

Timing the market impact from the transition will be difficult

These reforms could generate significant volumes and price moves in swap markets, but timing these will be difficult. Most pension funds expect to transition in 2026, but the regulator has a deadline of 2028 and delays are already anticipated (see chart). Some funds have recently commented that they prefer to wait for other pension funds to reform rather than being the “early bird”. On top of that, the political parties currently in Dutch coalition talks have expressed their concerns about the new pension system, leaving a small chance that the present implementation of the legal framework will be challenged again.

Pension funds are already delaying the expected transition



Source: ING, DNB

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