Rotman ICPM
International Centre for Pension Management

Rotman School of Management
UNIVERSITY OF TORONTO

ICPM Case Study

Fiduciary Management:
A Next Logical Step in the Evolution of Pension Management?

Rob Bauer

This case was written by Rob Bauer, Professor of Finance (Chair Institutional Investors), Limburg Institute of Financial Economics (LIFE), Maastricht University, Netherlands. Funding was provided by the Rotman International Centre for Pension Management, University of Toronto, Canada. This is a composite fictional Case Study based on historical facts.

For Further Information: **Rotman International Centre for Pension Management**
151 Bloor Street West, Suite 702
Toronto ON M5S 1S4 CANADA

Tel: 416.925.7525
Fax: 416.925.7377
icpm@rotman.utoronto.ca
www.rotman.utoronto.ca/icpm

FIDUCIARY MANAGEMENT:

A NEXT LOGICAL STEP IN THE EVOLUTION OF PENSION MANAGEMENT?

> *"This Directive thus represents a first step on the way to an internal market for occupational retirement provision organized on a European scale. By setting the 'prudent person' rule as the underlying principle for capital investment and making it possible for institutions to operate across borders, the redirection of savings into the sector of occupational retirement provision is encouraged, thus contributing to economic and social progress".*
>
> ***Directive 2003/41/EC on the activities and supervision of institutions of occupational retirement provision***
> ***European Parliament and Council, June 3, 2003*** [1]

CASE DESCRIPTION

A SURPRISE LETTER

Anton Timmermans, Chairman of the Board of Trustees of the Dutch industry pension fund *Bedrijfspensioen*, has to make a decision on short notice on how to respond to a surprise letter he received last evening. The letter, sent by Richard de Ridder, Chief Executive Officer of SCALE N.V., referred to a strategy document in which the Executive Board of SCALE brought forward a view on its long-term strategy in the European pension market for the next five years. The main message of the letter and strategy document was an informal request to remove the current third-party restriction that SCALE faced regarding its client base. A list of endorsements by Supervisory Board members of SCALE was also included.

Three years ago, *Bedrijfspensioen* and *Pensioenkas* had set up SCALE as a so-called pension delivery organization (PDO).[2] *Bedrijfspensioen* was originally set up in the early 1960s when an increasing number of small businesses emerged in the Netherlands.[3] *Pensioenkas* was another Dutch medium-sized industry pension fund responsible for the pension arrangement of accountants. Today, both pension funds equally own fifty percent of the shares of SCALE, which is structured as a Dutch public limited liability corporation or Naamloze Vennootschap (N.V.). Since the start of its activities, SCALE has been restricted to providing pension services to its current shareholders. Anton was one of the Board members that had been actively involved in establishing SCALE and defining its mission. At inception, it was clearly agreed that SCALE should fully focus on managing the assets of the two pension fund clients, who happen to be shareholders as well.

However, a series of recent strategy meetings of the Executive Board and Supervisory Board challenged the current mission statement of SCALE. For instance, the strategy document proposes that SCALE should target new client groups, within and outside the pension fund sector, as well as within and outside of the Netherlands, with a clear focus on Europe. This implied the removal of the original third-party restriction.

Anton wondered what exactly triggered this proposed mission change. As expected, the letter had also been sent to Kees de Boer, the newly appointed Chairman of the Board of Trustees of *Pensioenkas*. A quick phone call this morning revealed that Kees was equally surprised by this sudden change in direction. After a short discussion on the phone, the two Chairmen agreed that they would have a conference call at the beginning of the following week to discuss things further.

THE CONCEPTION OF A PENSION DELIVERY ORGANIZATION

Until a few years ago, both *Bedrijfspensioen* and *Pensioenkas* executed all pension service related tasks, including investments and administration, independently in two separate small-to-medium size legal structures (in this case a foundation or *stichting*). Inspired by a stream of research issued by the Toronto-based company CEM Benchmarking, representatives of the Board of Trustees of the two funds informally got together in early 2005 to discuss the possibility of a full merger of both organizations. CEM research showed that economies of scale play an important role in the modern management of pensions.[4] At the same time, it became clear that a full fusion of the two organizations would be far too complex. The main reason documented in the negotiation process was that the pension funds had diverse backgrounds. Participants originated from different industries and therefore different cultures. Moreover, the promised pension deals of the two funds were virtually incomparable. For instance, *Bedrijfspensioen* provided an old-fashioned, paternalistic, and purely defined benefit (DB) scheme without choice elements. On the other hand, *Pensioenkas* offered a blend of DB and defined contribution (DC) characteristics, generally with more degrees of freedom for its members.

Although the full merger negotiations were halted, it became clear that individually the two funds were too small to operate independently and cost-effectively in the fast-changing European pension fund market. Both funds had roughly €10 billion in pension assets. Despite this size, the management of both funds experienced severe difficulties to attract and retain high quality human capital necessary to compete in the pension services industry. Increasingly, both Board of Trustees received signals that the two respective executive organizations were not well enough equipped to deal with commercial providers of financial and administrative services in the market. Moreover, the perceived opportunities of achieving economies of scale were a major driver of the continuation of the merger process.

Consequently, the initial full merger talks were redirected to discuss the fusion of selected areas of expertise specific to each of the two pension delivery organizations without merging the pension plans. In the summer of 2006, the funds made public a decision to merge the two management organizations into a newly established pension delivery organization called SCALE N.V. (SCALE) In this new set-up, both funds would profit from increased economies of scale by pooling human capital and activities related to investment assets (including asset liability management and research). Moreover, the pension administration departments (including communication and call center management) could be merged, which would dramatically reduce the administration costs per participant in both pension plans. However, it was decided that the pension accumulation formulas of the two funds would remain separate, although their eventual convergence could be discussed in later stages of the merger process. From the start, SCALE has been fully owned by the two pension funds, which independently negotiated a Service Level Agreement (SLA) with SCALE. As shareholders, they unanimously decided that SCALE would provide *exclusive* investment management and administrative services to *Bedrijfspensioen* and *Pensioenkas*. This restriction would ensure low agency costs and hence a clear focus by the SCALE Executive Board on the preferences and interests of its clients and shareholders.

Throughout this process, Anton had been a very active member of the negotiation team on behalf of *Bedrijfspensioen*. He had not shared these historical details with Kees, the current Chairman of *Pensioenkas*, since he was appointed only a few months ago.

Dutch corporate law required that SCALE, being a public limited liability corporation, would create a Supervisory Board. During the merger process it also became clear that some of the negotiating Trustees of the two funds were interested in becoming members of the new Supervisory Board of SCALE. The newly established Supervisory Board consisted of nine members: each shareholder was represented by three Board members; two independent international experts in pension services; as well as an independent generalist with a political background in both the Netherlands and Europe who was asked to Chair the Supervisory Board. Two of the representing Board members were originally members of the Board of Trustees of the respective pension funds (one from each fund).[5]

The first decision made by the Supervisory Board was to appoint a new Chief Executive Officer for SCALE. Richard de Ridder was identified as the best person for the job. As the former Chief Executive Officer of *Bedrijfspensioen*, he was perfectly equipped to guide this new organization through an increasingly dynamic pension fund landscape. To a large extent, the executives of the two original pension fund organizations emerged as the new Executive Board of SCALE. The Chief Executive Officer of *Pensioenkas* and a few other executives of both funds retired early.

After the completion of the merger, the Boards of both *Bedrijfspensioen* and *Pensioenkas* are serviced and supported by small staff agencies (Pensioenbureau) of approximately three to five full time equivalents (FTEs). The staff is mainly responsible for the day-to-day monitoring of the outsourced services to SCALE and other service providers. Moreover, it plays an important role in facilitating the communication about strategic matters between the Boards of Trustees of their respective funds as well as the Supervisory Board and Executive Board of SCALE. In addition, the Boards of both pension funds agreed to meet regularly to discuss matters related to SCALE that were of equal interest to both parties. These meetings take place once or twice a year. So far, both parties were comfortable with the new set-up.

Figure 1 provides an overview of the pre- and post-merger organizational structure. Table 1 provides vital pre- and post-merger statistics of the two pension funds.

Figure 1: Pre- and Post-Merger Organizational Structures (2006 and 2007)

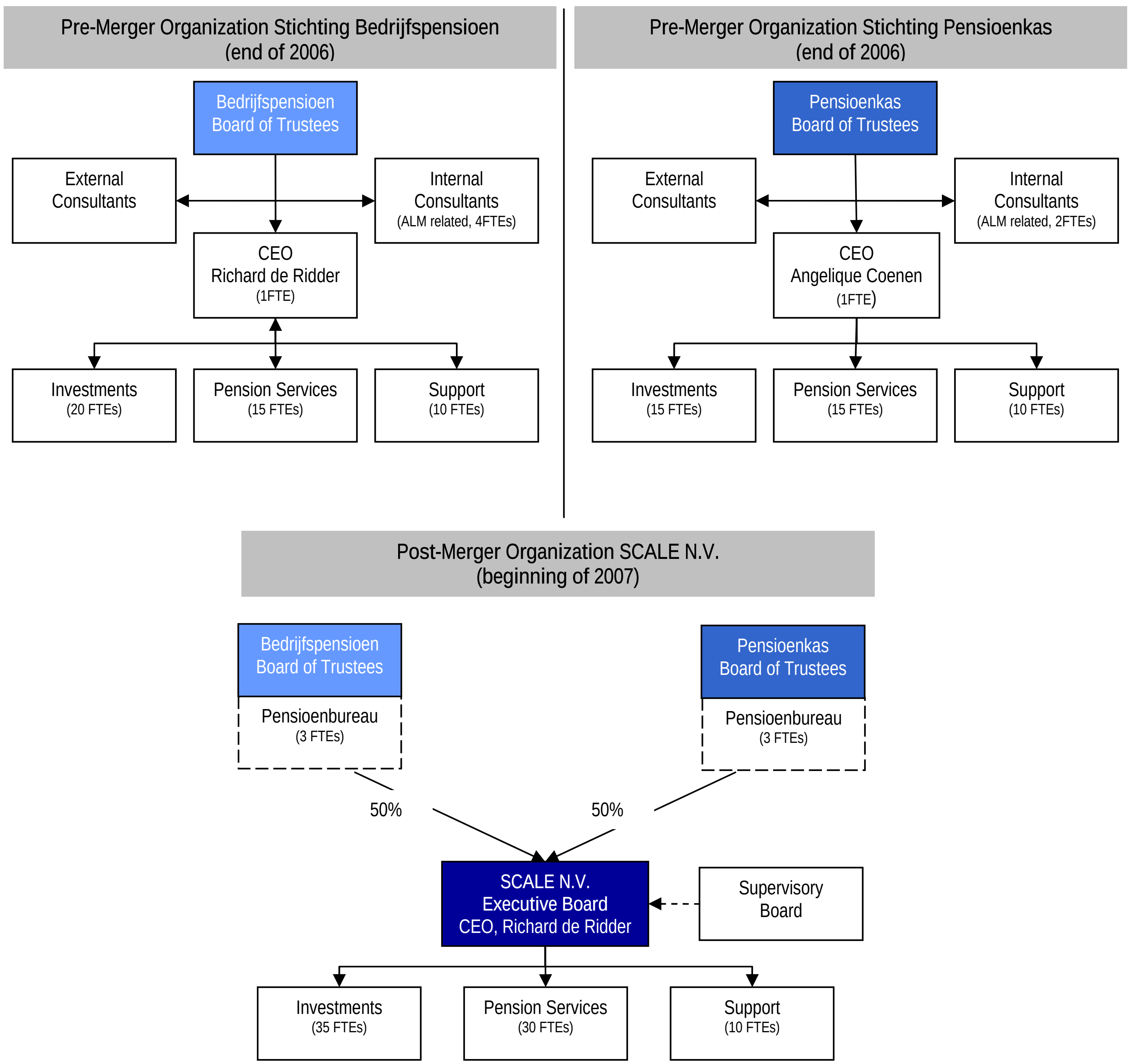


Table 1: Vital Statistics of Two Separate Pension Funds (end of 2006)

Statistics	Individual Foundation (end of 2006)		SCALE N.V. as Executive Organization (end of 2008)	
	Bedrijfspensioen	Pensioenkas	Bedrijfspensioen	Pensioenkas
Size (assets in €billion)	11	10	9	8
Costs (in basis points)	40	50	35	
Number of Employees	50	43	81	
Total Return Assets (average of last 10 years)	7.0%	6.6%	4.2%	3.9%
Net Value Added (in basis points)	6	-10	15	
Funding Ratio (market value)	132%	126%	102%	96%
Budget External Consultants (in €million)	5	3	1	
Number of Supervisory Board Members	N/A	N/A	9	

BRAINSTORMING IN THE COUNTRYSIDE

After reading and digesting the letter, Anton started reading through the bulky strategy document entitled *SCALE's Long-Term Strategy In A Dynamic European Pension Market.* In the introduction, the report referred to a series of recent brainstorm sessions in the countryside organized by the SCALE Executive Board. Essentially, the main goal of these informal gatherings was to evaluate the first two years of SCALE's existence. Furthermore, a discussion of the strategic direction for the upcoming five years was scheduled. Enthusiastic participation by all Executive Board members and most senior managers of SCALE brought forward several interesting observations and identified innovative ideas. In the final meeting, these were summarized in an internal memo that roughly resembled the first chapter of the strategy document Anton was reading. The main conclusions of the chapter are listed below:

1. SCALE is too small to be cost-effective and innovative in the long-term

As a result of the financial crisis, assets under management (AUM) at SCALE declined from €21 billion at inception (January 2007) to around €17 billion at the end of last year (December 2008). Most participants in the sessions had the opinion that SCALE, despite the recent merger, was still considered to be a relatively small player in the European pension services market, both in terms of assets under management and, as a result of the third-party restriction, in terms of client base. This notion probably explained the observation made by the internal control department that larger peers were able to supply their clients with pension and investment services at much lower cost levels. If SCALE was to double in size, by attracting new clients, it could imply a reduction in total cost levels (direct investment and administration costs) of roughly 10 basis points. This was confirmed by a recent cost-effective measurement study based on CEM Benchmarking data for US pension funds. Figure 2 shows average total fund costs (*All Funds*) in the period 1990-2006. Moreover, it shows total costs differences between the 30% largest pension funds and the 30% smallest pension funds. Larger funds have on average 15-20 basis points lower costs. In Figure 3 the corresponding yearly average holding sizes of the three categories are displayed.

Figure 2: Fund Costs

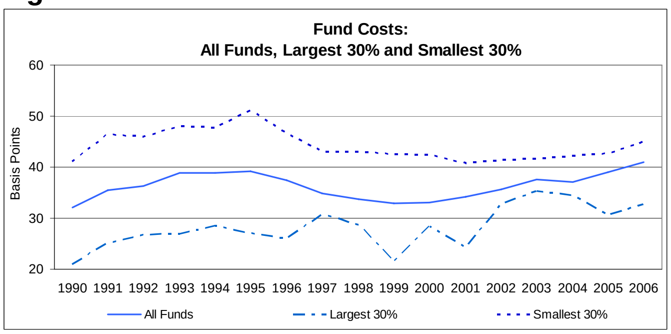
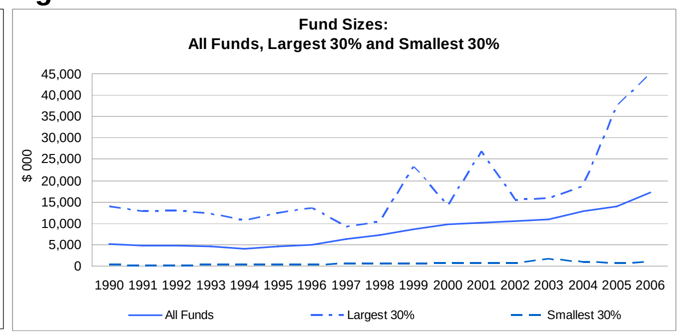


Figure 3: Fund Size



Source: Data provided by CEM Benchmarking Inc. Data in Figure 3 is shown in $US.

A recent issue of *The Ambachtsheer Letter* [6] provided additional insight into the scale and costs of pension funds:

> *"The economies of scale concept is a well-known phenomenon in micro economics and industrial engineering. Generally speaking, once a plant and equipment are in place, increased volumes push down unit costs until scale economies become diseconomies. CEM Benchmarking has the data to measure the impact of scale on unit costs in both its pension benefit administration and pension investment databases. The scale impact metrics are set out in [Table 2] for the global benefit administration and investment databases at CEM Benchmarking. The table provides additional information on the membership and fund size and cost ranges captured in the databases, as well as on statistical significance.*
>
> *[Table 2] indicates that in the pension benefit administration database, on average, a 10x increase in the membership size of the plans is associated with $108 drop in benefit administration costs per member. Similarly, in the pension investment database, on average, a 10x increase in the $value of the funds is statistically associated with a 0.17 percentage point (17 basis points) drop in total investment costs expressed as a percentage of assets under management. Both of these scale impact metrics display high statistical significance. We should note here that the complete database was used to estimate a single scale impact coefficient in each case.*
>
> *This should not be taken to mean that the scale effect is necessarily (log-linear) constant across the entire range of experience captured in the benefit administration and investment databases. For example, more granular analyses might show that the scale effect is more pronounced at the lower ends of the size*

ranges than indicated by the calculated scale impact metric. We leave this type of more detailed analysis for another time. We did confirm that the scale impact was pervasive at a more micro level in the investment database (e.g., at the asset class level, for custodial services, consulting services). In addition, there was an increasing incidence of lower-cost in-sourcing of some of these services as scale increased. However, there was some offset to these scale impacts due to larger funds using a greater proportion of higher-cost asset classes (e.g., private equity and hedge funds).”

Table 2: Costs vs. Scale in Pension Plans

	Benefit Administration	Investment
Scale Range In Database	0.1 – 2 million members	$0.1 - $350 billion
Cost Range In Database	$24 - $550/member/year	0.05% – 1.31%/assets/year
Scale Impact Metric	-108 ($ch. per 10x incr.)	-0.17 (%ch. per 10x incr.)
Statistical Significance	High (t-value= -7)	High (t-value= -14)

Source: The Ambachtsheer Letter, Issue 280, May 2009. Data provided by CEM Benchmarking Inc.

Additionally, a recent independent client satisfaction survey showed that clients and competitors in the pension services industry perceived SCALE as a mediocre performer on pension management innovation. Unanimously, participants felt that this perception would almost certainly endanger the long-term reputation of SCALE.

2. The restriction to serve third-party clients should be removed

The Dutch pension landscape changed rapidly in the last decade. For instance, an increasing number of smaller (corporate) funds turned over the complete pension plan to service providers comparable to SCALE. Unlike SCALE, these commercial organizations operate with clear for-profit intentions. Interestingly, representatives of some of the switching pension funds asked SCALE Executive Board members explicitly if SCALE would like to compete for these mandates. The standard response by SCALE was that given its background, the pension delivery organization knows how to deal with small and medium -sized pension fund organizations and that unfortunately, SCALE was not allowed to add any new clients to their portfolio. Moreover, an increasing number of smaller and medium-sized Dutch pension funds went through a similar merger process in the past few years. This consolidation trend was expected to accelerate in the next five to ten years.

Many Executive Board members were faced with the same questions the two owners of SCALE had faced three years ago. All in all, this series of developments decreased the number of independent pension delivery organizations in the Netherlands. The ‘Seven Sisters’ of Dutch pension fund management were gradually emerging. Would SCALE be part of that family in the long run?

Table 3 provides some information on the market for pension funds in Europe.[7] *Panel A* clearly shows that some less developed pension markets will grow more than others and that, in particular, the well-developed Dutch pension market will grow only marginally in the period until 2015. *Panel B* shows that currently only twenty pension funds in the Netherlands actually have more than €5 billion AUM.

Table 3: The Market for Pension Funds in Europe

Panel 1 Country	2005 (AUM €million) Actual	2015 (AUM €million) Forecast
Belgium	15	99
Italy	49	145
Germany	108	782
Spain	112	187
France	124	372
Netherlands	780	991
United Kingdom	1541	2204
Panel B Pension Fund Size (NL)	**Quantity 2005**	
€250 million to €1 billion	96	
€1 billion to €5 billion	40	
€5 billion to €15 billion	14	
€15 billion to largest	7	

Source: OECD and Mercer Oliver Wyman

3. *Fiduciary management*

The concept of fiduciary management had become very popular in the past few years, particularly in the Netherlands. The Boards of many funds turned part of/or complete management of a pension plan over to third parties. Interestingly, the fiduciary market in the Netherlands had been developed initially by several Anglo-Saxon financial service providers (e.g. Goldman Sachs and Blackrock). Spin-off companies of traditional asset management organizations now offer a range of fiduciary management services to pension funds in Europe. In the Dutch market they are relatively successful, but there are clear indications that other pension markets are adopting this concept in an increasing manner. More recently, a few pension delivery organizations owned by Dutch pension funds have also discovered the interest in fiduciary management. In most cases, these institutions have substantially more assets under management than SCALE. Good examples are Mn Services, PGGM, and APG.[8]

The left column of Figure 4 provides an example of a recent mandate valued at €3.2 billion awarded to Mn Services by the Dutch merchant navy pension fund. The middle column of Figure 4 refers to a recent external mandate valued at €300 million awarded to PGGM by the Dutch pension fund for the private security industry.

4. The European pension market will change dramatically

Another recent development is the desire by the Dutch government to introduce a new type of financial institution which can implement pension schemes in Europe: Algemene Pensioeninstelling (API) or General Pension Institution. An API is intended to grant a Dutch pension provider with a European passport, which makes full use of the freedom provided by the European Pension Directive for the cross-border provision of pension expertise.[9] Interestingly, commercial insurance companies, pension funds or employers, and employees or their respective organizations are allowed to set up an API as well. Furthermore, the API is allowed to compete with insurance companies, pension funds, and foreign pension insurers. However, there is still a lot of uncertainty about the exact level of freedom that will be granted to the API. Nonetheless, it is fair to assume that the European market for pensions and insurance will change dramatically in the next decade. Pension funds will cross borders or set up special vehicles to do so. Insurance companies and other financial services organizations will penetrate into local pension markets more than before. SCALE can simply not neglect this development.

The right column of Figure 4 details a cross-border deal valued at €100 million between the Dutch APG group and PensPlan, an Italian pension provider.

5. The financial crisis requires immediate action

The final topic that emerged in the brainstorm sessions was that the current financial crisis environment accelerated the worldwide demise of DB pension schemes. Most senior staff agreed that the trend towards DC would continue, and it was argued that in such an environment, SCALE would simply be forced to target a broader client group than before. One of the possible extensions could then be the development of a broad-based product range that is suitable in a predominantly DC dominated pension landscape. This would be in the interest of both new and existing clients, but most importantly, it would ensure the sustainability of SCALE as an independent pension delivery organization.

Figure 4: Dutch Pension Delivery Organizations in Action

Mn Services to Deliver Multi-Manager for Merchant Navy

The €3.2bn occupational pension fund for the Dutch merchant navy (Bedrijfspensioenfonds voor de Koopvaardij), has appointed fiduciary manager Mn Services to act as a multi-manager and adviser to the fund. A spokesman for Mn Services stopped short of describing this to IPE as the Dutch merchant shipping fund adopting fiduciary management, and instead stressed Mn Services will be responsible for managing the fund's assets as a multi-manager as well as have an advisory role, both at a strategic level and on investment policy, but is also known for its expertise in fiduciary management. The fund appointed investment consultant Watson Wyatt last year to review its investment arrangement after reviewing Achmea as a fund manager (see earlier IPE story: "Dutch navy sinks Achmea")

It is now unclear what will happen to F&C's status as investment manager to the fund following Mn's appointment, as pension fund officials were unavailable for comment at the time of publication. That said, the Mn Services spokesman said "the transition will now begin and take around two months". But in a written statement a pension fund spokesman described the decision to hand the mandate to Mn Services as "a close finish", further arguing "the decisive factor for us was the balance between the quality of the services on offer and Mn Services' understanding of the specific nature of our fund". The Merchant navy fund, which now provides pensions benefits for 55,000 members, and on behalf of over 200 employers had a cover ratio in mid-February 2008 of 146%. As one of the largest asset managers and pensions administrators in the Netherlands, Mn Services today manages assets of over €61bn and administers the pensions of over 1.1 million people and over 33,000 employers.

Source: Investments and Pensions Europe, March 18, 2008

PGGM Secures Fresh Pension Fund Mandate

The €300m pension fund for the Dutch private security industry has awarded PGGM an external mandate to manage the entire pension fund.
Tom Uittenbogaard, president of the governing board of the security pension scheme, said PPGM, the asset management arm of PfZW, pension fund to the healthcare sector, was selected following guidance from its consultant Avida International and with the cooperation of CMC.

"Both from a professional and cultural aspect, PGGM came forward as best party for our orientation. PGGM knows the pension world like no other and that protects the interests of our participants. Moreover, PGGM Investments has developed a responsible philosophy through its history with the care and health sector which we fully support."

The industry-wide pension fund for the private security industry was created in 1990 and now manages the pension scheme for 320 private security ventures in the Netherlands and serves 40,000 deferred members and pensioners.

Alongside its latest appointment PGGM Investments now manages assets under management of over €67bn for PfZW and AENA, the occupational pension fund for independent artists.

Source: Investments and Pensions Europe, April 21, 2009

APG Set To Unveil Its Corporate Strategy

While APG Investments and Cordares' asset management arm are currently separate entities, they will be merged as a single operation mid way through the year, a spokesman for APG has confirmed. The APG asset management division currently manages the assets of its €173bn parent pension fund but Cordares has already won the group its first external mandate to manage pension fund assets, as PensPlan, the Italian pension provider, gave it a mandate to manage €100m in assets in October 2008. (See earlier IPE story: APG Group signs cross-border deal with PensPlan). Preparations for the group's international expansion into the market would support the group's intended drive to pick up external business, as cited by Jaap Maassen, APG's director of pension administration, last year, when he confirmed APG was keen to win new business from large, mainly defined benefit type pension funds, as well as offer its asset management skills. (See earlier IPE story: APG eyes European pension assets). IPE also understands APG is now embarking on the key element of its bid to compete with mainstream asset managers for pension fund business as the firm is understood to be developing 14 investment strategies to be taken to the wider market.

APG was officially spun off as a separate but wholly-owned entity of ABP pension fund on 3 March last year, and then entered into a merger agreement with Cordares in April last year which gave APG a 51% share of the other firm.

Source: Investments and Pensions Europe, February 27, 2009

A SOLID BUSINESS CASE

Shortly after the lively brainstorm sessions in the countryside, Richard de Ridder, the Chief Executive Officer of SCALE, realized that he had to involve the members of the Supervisory Board, representing shareholders and other stakeholders of SCALE, in this discussion. Richard was convinced that his Supervisory Board members would corroborate the opinion of the Executive Board that the changing pension landscape required a redirection of the long-term strategy and associated mission statement of SCALE. The expected dynamic environment would require a different set of services offered to members of the two pension plans. Moreover, only a broader client base would ensure an outstanding long-term performance on cost-effectiveness, operational excellence, innovation strength, and other key performance indicators of SCALE.

As a result, Richard de Ridder organized a strategy meeting with all Executive Board and Supervisory Board members a few weeks after the brainstorm sessions. After a lively debate, it was unanimously concluded that SCALE needed to re-focus its strategy to ensure the sustainability of its organization. All participants in this discussion stressed the fact that these changes would need to be founded on a solid business case, which showed that both current and existing clients of SCALE would profit from the proposed change in direction.

The business case was detailed in the second chapter of the strategy document that Anton was reading. Some of the arguments mentioned in the document actually reminded him of a recent article in the *Rotman International Journal of Pension Management*.[10] At the end of the chapter, the main points for change in long-term strategy were listed, followed by a detailed description of the business case:

1. SCALE requires a sharp increase in assets under management

This essentially implies the removal of the restriction to serve third-party clients. For this reason, SCALE should start up a dialogue with its shareholders *Bedrijfspensioen* and *Pensioenkas* as soon as possible to discuss this matter. Only when SCALE grows in size it will be able to:

- i) attract and retain high quality personnel
- ii) deliver pension services in a cost-effective and operationally efficient way
- iii) produce innovative product ranges in a flexible way
- iv) increase its visibility and power in the market

2. SCALE needs to broaden its client base in more than one dimension

Why should it only focus on the institutional pension market? Currently, SCALE is active in institutional pension and investments services. The strategy document highly recommends that SCALE target institutional clients in general. This includes corporate and public pension funds, endowments, charity foundations, governments, municipalities, and other institutional clients. Of course, these clients should have a minimal amount of AUM to be interesting from a profit margin point of view. However, most Executive Board members believe that investments in efficient investment and administration processes and account management activities will ensure that most institutional clients could be served efficiently and in a cost-effective manner.

3. SCALE should operate beyond the boundaries of the Dutch (pension) market

The Dutch market is too small, it will not grow as much as other pension fund markets, and it is too competitive and crowded to let SCALE be successful in the next decade. Hence, a multi-country marketing strategy with a focus on the fast growing pension markets in Germany, France, and Italy will have to be developed soon.

4. SCALE needs to develop a new marketing strategy

The new marketing strategy needs to clearly define which clients are targeted and in which geographic region. The strategy will need to encompass a detailed description of SCALE's definition of fiduciary management. This development clearly requires the hiring of human capital with a background in marketing and account management. As a result, the focus of SCALE will gradually shift from providing only asset management and pension administration services to a broader combination of asset management, pension administration, and account management services.[11]

The second chapter of the strategy document continued by stating that SCALE stakeholders will only accept the new strategy if there is a solid business case for these changes from the viewpoint of existing clients.

Anton suddenly understands why his former colleague in the Board of Trustees of *Bedrijfspensioen* contacted him a few weeks ago in his new position as Supervisory Board member of SCALE. Anton had dinner with him and informally discussed the Dutch pension market in general and SCALE's third-party restriction in particular. At the time, Anton did not realize that SCALE was actually reconsidering its long-term focus. However, he did remember that he clearly stated during their conversation that as a Board member of *Bedrijfspensioen*, he would judge the desirability of a removal of the third-party restriction strictly from the viewpoint of the current beneficiaries. As a Board Trustee, Anton feels implicitly directed by the well-known prudent person rule in making strategic decisions in the fund.[12] Therefore, any change in strategy by SCALE should at least be beneficial to the participants of the two pension funds that initially set up SCALE.

For this reason, Anton is not surprised that the second chapter continued with explicit references to advantages for participants of the two existing clients. The main ingredients of the business case were:

1. Improved cost-effectiveness

The removal of the third-party restriction will increase AUM to roughly double its current size in the next five years and an increase in potential in the years thereafter. It is expected that the same cost reductions will take place in the pension services department. Ultimately, this will result in lower cost levels per €AUM. Predictions of cost reductions as a result of economies of scale made by the CFO of SCALE range from 5-15 basis points.

2. Better access to interesting investment opportunities

Because of its increased size, SCALE will have better access to interesting, innovative and high-returning investment opportunities, especially in the realm of alternative asset classes. In the near future, SCALE will be able to participate in a more interesting deal flow and at better conditions than before. For instance, investments in infrastructure, private equity, and direct real estate projects will increase considerably in size. As a result, SCALE will be able to provide more innovative investment products and investment strategies to both existing and new clients. Eventually, this will result in better-diversified portfolios and increased risk-adjusted returns for current and existing clients. SCALE's investment department expects that the Net Value-Added of the existing clients will increase to 50-100 basis points in the next few years.[13]

3. Increase in the quality of human capital

Working at SCALE will require more talented resources due to the scope of demands on the pension delivery organization. The development of more innovative investment strategies, combined with an elaborate multi-client strategy will require higher skill levels of the workforce. Ultimately, the increased ambition level will ensure that SCALE will be able to attract and retain top talent and consequently ensure high quality pension and investment services to all clients in the long term.

4. Transparent pricing

The commitments to new clients, through the fiduciary management vehicle, will be structured in long-term contracts, while at the same time ensuring that existing clients (the two pension funds, who happen to be shareholders as well) are not disadvantaged in any way. A transparent pricing strategy based on a number of relevant parameters, such as size and the complexity of assets under management, including market based fees, will be developed. In a parallel way, new clients should be treated with the same level of care as existing clients.

The summary of the strategy document states that these cornerstones of the business case will eventually materialize in higher risk-adjusted net investment returns on a total plan level. Moreover, SCALE will be perfectly prepared for a sudden demand for DC arrangements. Both existing and new clients will profit from the change in strategy and the associated advantages. Finally, all Executive Board and Supervisory Board members endorse the strategy document.

In the last part of the letter accompanying the strategy document, Anton and Kees are invited to discuss the strategic document over dinner with a selected group of Executive Board and Supervisory Board members. Finally, Richard de Ridder asked both Chairmen to treat the strategy document as highly confidential.

HOW TO RESPOND?

After reading and digesting the letter and the strategy document, Anton now has to decide how to respond to the proposal in general and to the dinner invitation in particular.

Several thoughts cross his mind. First of all, he is surprised that the strategic changes of two years ago seem to be outdated already. So far, he did not get any alarming signals from fellow Trustees that the participants of *Bedrijfspensioen* are not satisfied with the current situation. On the contrary, the independent client satisfaction survey in the crisis year 2008 showed that clients were generally positive about the level of pension services provided by SCALE. If the new strategy is really necessary, why did Richard de Ridder never raise this topic before in a formal meeting of the Board of Trustees? And why did his former Board of Trustee colleague in the Supervisory Board of SCALE not contact him before?

Second, Anton is worried. In this new setup, SCALE will be a full-fledged commercial organization that has to juggle between the preferences of existing and new clients. Furthermore, SCALE has the ambition to strive for high risk-adjusted real returns on the one hand and to broaden its client base and AUM on the other. Is it really possible to meet all these goals at the same time? For now, Anton is not really convinced that existing clients and new clients will be served equally in this new setting. From his perspective, he especially needs more clarity on the safeguards for existing clients. Which future governance structure is able to both protect his beneficiaries and reap the benefits of the ambitions of SCALE? Moreover, is there any conflict of interest that can emerge in the current structure?

Third, Anton is unsure whether the statements in the strategy document are indeed realistic. Is SCALE not able to work cost-effectively with the current size of €17 billion assets under management? Will the European pension market indeed grow as fast as predicted by SCALE? Will SCALE be able to win mandates of sufficiently large clients? Or will it focus on a large number of small institutional clients? And is the demise of DB funds really happening? Anton does not feel comfortable in answering any of these questions. If there is so much uncertainty, why make a decision now?

Fourth, Anton wonders whether there are any legal or regulatory issues that play a role here. As a Board member and Chairman of *Bedrijfspensioen*, Dutch pension law requires him to act in the best interest of the beneficiaries, i.e. existing clients, of his fund. Is a move to a multi-client strategy indeed in the interest of current participant and if yes, how will that be documented? Anton is well aware of the fact that ultimately the Board of Trustees is responsible for SCALE's ambitious activities in the European pension market.

Finally, Anton is uncertain on how to proceed. Should his next step be to organize a special Board meeting to discuss the strategy document? Or should he first give Kees de Boer, the Chairman of *Pensioenkas*, a phone call to discuss how to respond as a coalition of shareholders? Or should he simply call Richard de Ridder and ask him to explain the new strategy in more detail?

APPENDIX LIST OF TABLES AND FIGURES

Figure1: Pre- and Post-Merger Organizational Structures (2006 and 2007)

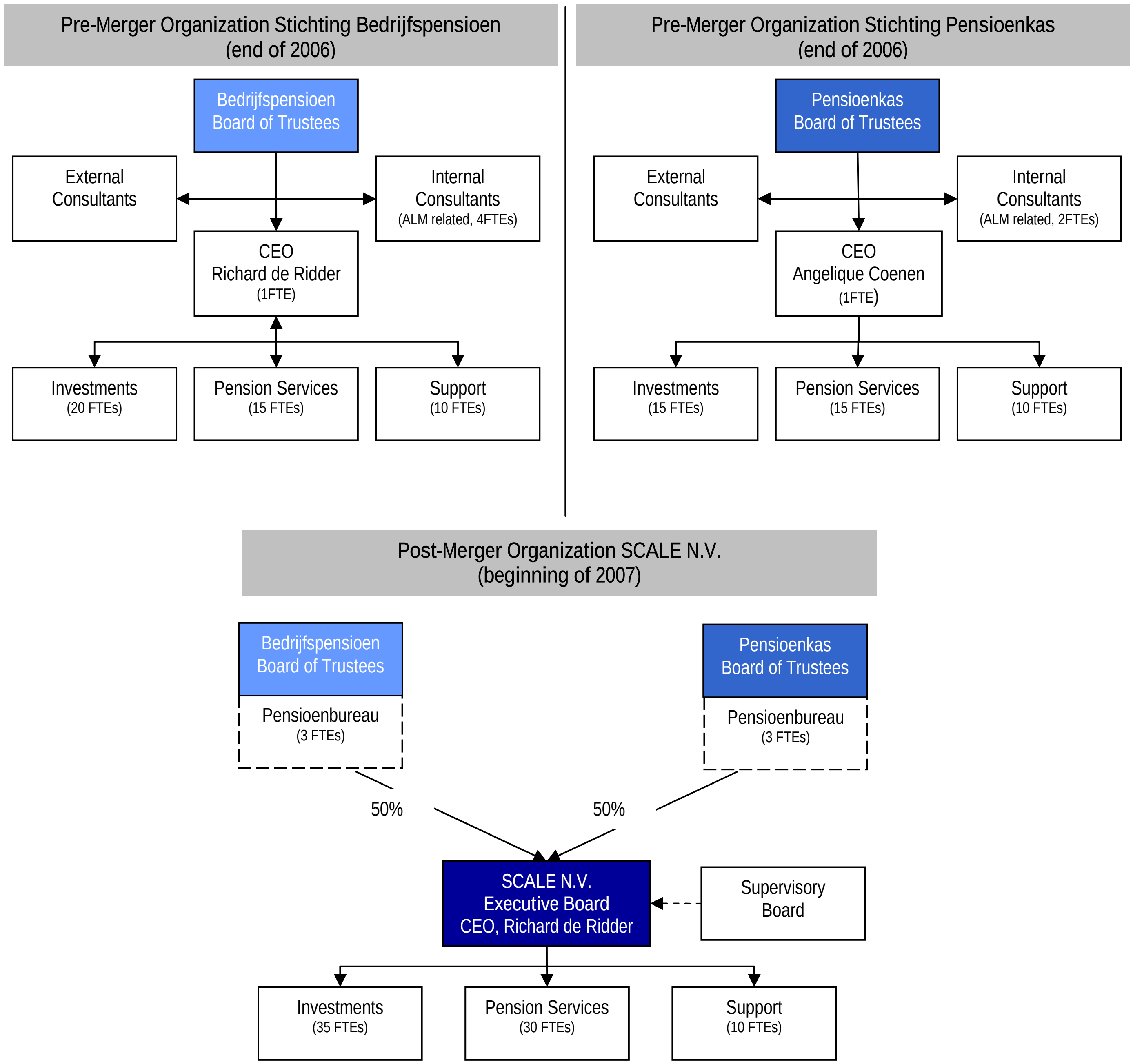


Table 1: Vital Statistics of Two Separate Pension Funds (end of 2006)

Statistics	Individual Foundation (end of 2006)		SCALE N.V. as Executive Organization (end of 2008)	
	Bedrijfspensioen	Pensioenkas	Bedrijfspensioen	Pensioenkas
Size (assets in €billion)	11	10	9	8
Costs (in basis points)	40	50	35	
Number of Employees	50	43	81	
Total Return Assets (average of last 10 years)	7.0%	6.6%	4.2%	3.9%
Net Value Added (in basis points)	6	-10	15	
Funding Ratio (market value)	132%	126%	102%	96%
Budget External Consultants (in €million)	5	3	1	
Number of Supervisory Board Members	N/A	N/A	9	

Figure 2: Fund Costs

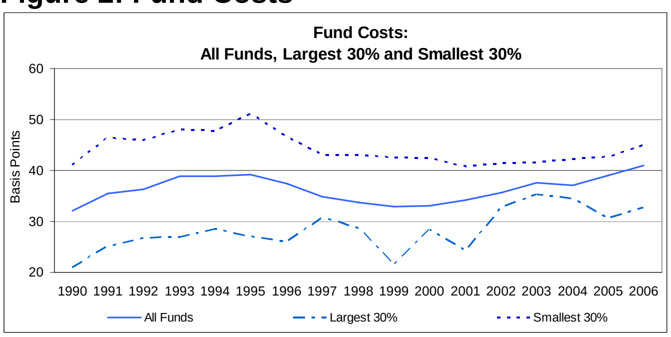
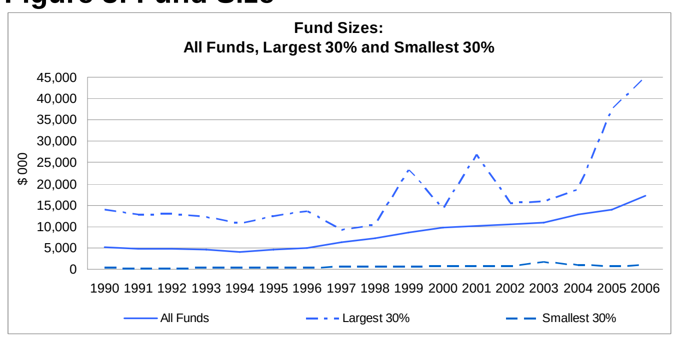


Figure 3: Fund Size



Source: Data provided by CEM Benchmarking Inc. Data in Figure 3 is shown in $US.

Table 2: Costs vs. Scale in Pension Plans

	Benefit Administration	Investment
Scale Range In Database	0.1 – 2 million members	$0.1 - $350 billion
Cost Range In Database	$24 - $550/member/year	0.05% – 1.31%/assets/year
Scale Impact Metric	-108 ($ch. per 10x incr.)	-0.17 (%ch. per 10x incr.)
Statistical Significance	High (t-value= -7)	High (t-value= -14)

Source: The Ambachtsheer Letter, Issue 280, May 2009. Data provided by CEM Benchmarking Inc.

Table 3: The Market for Pension Funds in Europe

Panel 1 Country	2005 (AUM €million) Actual	2015 (AUM €million) Forecast
Belgium	15	99
Italy	49	145
Germany	108	782
Spain	112	187
France	124	372
Netherlands	780	991
United Kingdom	1541	2204
Panel B Pension Fund Size (NL)	**Quantity 2005**	
€250 million to €1 billion	96	
€1 billion to €5 billion	40	
€5 billion to €15 billion	14	
€15 billion to largest	7	

Source: OECD and Mercer Oliver Wyman

Figure 4: Dutch Pension Delivery Organizations in Action

Mn Services to Deliver Multi-Manager for Merchant Navy

The €3.2bn occupational pension fund for the Dutch merchant navy (Bedrijfspensioenfonds voor de Koopvaardij), has appointed fiduciary manager Mn Services to act as a multi-manager and adviser to the fund. A spokesman for Mn Services stopped short of describing this to IPE as the Dutch merchant shipping fund adopting fiduciary management, and instead stressed Mn Services will be responsible for managing the fund's assets as a multi-manager as well as have an advisory role, both at a strategic level and on investment policy, but is also known for its expertise in fiduciary management. The fund appointed investment consultant Watson Wyatt last year to review its investment arrangement after reviewing Achmea as a fund manager (see earlier IPE story: "Dutch navy sinks Achmea")

It is now unclear what will happen to F&C's status as investment manager to the fund following Mn's appointment, as pension fund officials were unavailable for comment at the time of publication. That said, the Mn Services spokesman said "the transition will now begin and take around two months". But in a written statement a pension fund spokesman described the decision to hand the mandate to Mn Services as "a close finish", further arguing "the decisive factor for us was the balance between the quality of the services on offer and Mn Services' understanding of the specific nature of our fund". The Merchant navy fund, which now provides pensions benefits for 55,000 members, and on behalf of over 200 employers had a cover ratio in mid-February 2008 of 146%. As one of the largest asset managers and pensions administrators in the Netherlands, Mn Services today manages assets of over €61bn and administers the pensions of over 1.1 million people and over 33,000 employers.

Source: Investments and Pensions Europe, March 18, 2008

PGGM Secures Fresh Pension Fund Mandate

The €300m pension fund for the Dutch private security industry has awarded PGGM an external mandate to manage the entire pension fund.

Tom Uittenbogaard, president of the governing board of the security pension scheme, said PPGM, the asset management arm of PfZW, pension fund to the healthcare sector, was selected following guidance from its consultant Avida International and with the cooperation of CMC.

"Both from a professional and cultural aspect, PGGM came forward as best party for our orientation. PGGM knows the pension world like no other and that protects the interests of our participants. Moreover, PGGM Investments has developed a responsible philosophy through its history with the care and health sector which we fully support."

The industry-wide pension fund for the private security industry was created in 1990 and now manages the pension scheme for 320 private security ventures in the Netherlands and serves 40,000 deferred members and pensioners.

Alongside its latest appointment PGGM Investments now manages assets under management of over €67bn for PfZW and AENA, the occupational pension fund for independent artists.

Source: Investments and Pensions Europe, April 21, 2009

APG set to unveil its corporate strategy

While APG Investments and Cordares' asset management arm are currently separate entities, they will be merged as a single operation mid way through the year, a spokesman for APG has confirmed. The APG asset management division currently manages the assets of its €173bn parent pension fund but Cordares has already won the group its first external mandate to manage pension fund assets, as PensPlan, the Italian pension provider, gave it a mandate to manage €100m in assets in October 2008. (See earlier IPE story: APG Group signs cross-border deal with PensPlan). Preparations for the group's international expansion into the market would support the group's intended drive to pick up external business, as cited by Jaap Maassen, APG's director of pension administration, last year, when he confirmed APG was keen to win new business from large, mainly defined benefit type pension funds, as well as offer its asset management skills. (See earlier IPE story: APG eyes European pension assets). IPE also understands APG is now embarking on the key element of its bid to compete with mainstream asset managers for pension fund business as the firm is understood to be developing 14 investment strategies to be taken to the wider market.

APG was officially spun off as a separate but wholly-owned entity of ABP pension fund on 3 March last year, and then entered into a merger agreement with Cordares in April last year which gave APG a 51% share of the other firm.

Source: Investments and Pensions Europe, February 27, 2009

ENDNOTES

[1] Published in the *Official Journal of the European Union*, September 23, 2003. See Preamble, Item Number 6.

[2] The official names of both organizations are *SPf Bedrijfspensioen* and *SPf Pensioenkas.* In the remainder of the Case Study we will use *Bedrijfspensioen* and *Pensioenkas*.

[3] Unions representing employers and employees in the small businesses sector and the Dutch government decided unanimously that the labor force of this sector was required to join the then newly established pension fund arrangement *Bedrijfspensioen*. Gradually, but steadily, the fund increased in size.

[4] See, for instance, Ambachtsheer, Keith (2007), "Pension Revolution: A Solution to the Pensions Crisis", Chapter 34, *Wiley Finance*, New Jersey. See also Bauer, Rob and Rik Frehen (2008), "The Performance of US Pension Funds: New Insights into the Agency Costs Debate". SRRN: http://papers.ssrn.com/sol3/papers.cfm?abstract_id=965388. See also Bauer, Rob and Luc Kicken (2008), "The Pension Fund Advantage: Are Canadians Overpaying their Mutual Funds?", *Rotman International Journal of Pension Management*, Volume 1, Issue 1, Fall 2008 pp. 64-71. DOI: 10.3138/rijpm.1.1.64. See also, Ambachtsheer, Keith and Rob Bauer (2007), "Losing Ground: Do Canadian Mutual Funds Produce Fair Value for their Customers?", *Canadian Investment Review*, Spring 2007, pp. 8-14.

[5] The number of Board of Trustees Members remained constant with eleven members from each fund.

[6] Excerpt provided by Keith Ambachtsheer from *The Ambachtsheer Letter*, Issue # 280, May 2008.

[7] These tables are adaptations from: Roderick Munsters (2008), "The Conception of APG: Reorganizing Pension Delivery in The Netherlands", *Rotman International Journal of Pension Management*, Volume 1, Issue 1, Fall 2008 pp. 12-13. DOI: 10.3138/rijpm.1.1.12.

[8] A recent development in Canada shows that the concept of fiduciary management crossed the Atlantic already. The Ontario Government is changing the law that created Ontario Teachers' Pension Plan (OTPP) so that the organization can start accepting third-party mandates. This decision was based on scale-related data that came from the CEM Benchmarking database, and was used in a study entitled "A Fine Balance: Safe Pensions, Affordable plans, Fair Rules" published by the Ontario Expert Commission on Pensions in October 2008**.** The Government's rationale is that smaller pension plans should have access to scale and specialized expertise. In a recent speech, Michael Nobrega, Chief Executive Officer of Ontario Municipal Employee Retirement System (OMERS), stated at a Conference Board of Canada event held April 21, 2009 that his fund is now open for business and is actively seeking mandates to manage other pension funds' assets.

[9] The API can be regarded as 'an institution of occupational retirement provision', see directive 2003/41/EC on the activities and supervision of institutions of occupational retirement provision issued by the European Parliament and of the Council of June 3, 2003.

[10] Roderick Munsters (2008), "The Conception of APG: Reorganizing Pension Delivery in The Netherlands", *Rotman International Journal of Pension Management*, Volume 1, Issue 1, Fall 2008, pp. 12-13. DOI: 10.3138/rijpm.1.1.12.

[11] This is reflected in the new organizational structure of SCALE N.V. as shown in Figure 1.

[12] See Article 18, Section 1a of Directive 2003/41/EC of the European Parliament and Council. *"Member States shall require institutions located in their territories to invest in accordance with the 'prudent person'*

rule and in particular in accordance with the following rules: (a) the assets shall be invested in the best interests of members and beneficiaries. In the case of a potential conflict of interest, the institution, or the entity which manages its portfolio, shall ensure that the investment is made in the sole interest of members and beneficiaries..."

[13] Some of the Board members put forward the idea to establish a separate company that is responsible for sourcing interesting and high-returning projects in alternative asset classes. This could enable the inevitable attraction of top talent in this field without the restrictions of salary structure in the mainstream asset management organization. However, for now it was decided to leave this development opportunity for the next strategic evaluation.

Notes

[this page left blank]

Rotman
ICPM
International Centre for
Pension Management

Rotman School of Management
UNIVERSITY OF TORONTO