European Rates Watch

Dutch Pension Fund indexation & market impact

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Rates Research
Europe

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PF: Pension Funds

ASW: asset swap

OTM: out of the money

DC: defined contribution

Pension indexations in Jan-23 supported 10s30s flattening

In Q4 last year, Dutch Pension Funds announced large indexations of pensions for Jan23. This mattered for the EUR curve as it drove funds to receive rates and buy bonds in the long end. As outlined early December (see liquid insight 8-Dec-22), the link between the two comes from the fact that indexation increases the notional of all liabilities, and thereby mechanically lowers the interest rate hedge. In the context of the transition to a new Defined Contribution (DC) system, and with consensus geared towards lower rates in coming years, it was natural to assume funds would try to counteract this reduction in their interest rate hedge. To offset the impact of Jan-23 indexation on their rate hedge ratios, we estimated that the top 5 funds would need to receive €50mln/01 in rates.

We are monitoring indexation news again…

Since March, Dutch pension funds' activity in swaps appears to have been limited, with 10s30s steepening more than implied by 2s10s and vol in Mar-May (Exhibit 1). Quarter-end related receiving may now be ongoing, but eyes are on potential indexation news that could generate larger receiving needs. Last year, a number of funds had indexed in July or October already. Some can index pensions more than once a year and quickly made use of the temporary reduction in the threshold for indexation (min policy funding ratio of 105% instead of 110%, from 1-Jul-22 - Exhibit 4). The next key indexation date is Jan-24, but we cannot rule out intermediary indexation again. Dutch inflation is still running high (5.8% in May) and Minister Schouten announced last week that the period of lower indexation threshold would be extended from mid to end of 2023, with funds no longer required to give a bridging plan by Sep 1st for DC transition to benefit from this.

… but acknowledge 5 reasons why impact could be smaller

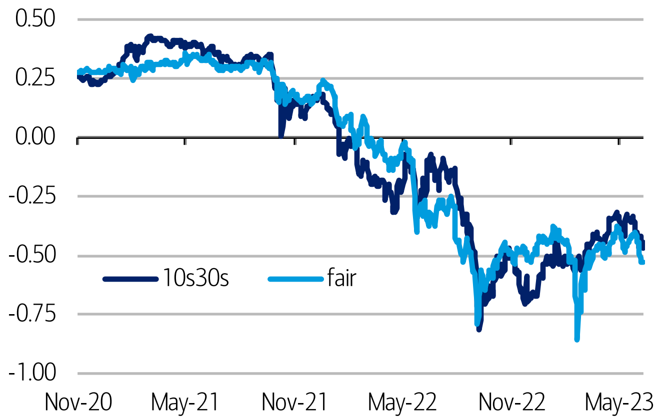
The impact of the next indexation rounds on the EUR 10s30s swaps curve is likely to be smaller than what was observed in Dec-22 to Feb-23. There are five reasons for that: (1) inflation is lower, (2) funding ratios are lower, (3) interest rate hedge ratios are higher, (4) more of the duration increase could be done in bonds, and (5) more of the receiving could happen in the belly of the curve rather than the long end, to prepare for the impact of the transition to DC. Exhibit 5 shows the amount of receiving that may be required under different indexation scenarios to maintain stable interest rate hedges.

Three takeaways on curve, swap spreads and swaptions

Given the above, we believe that the dynamic of the 10s30s swaps curve can remain driven by the 10y, with scope for bear flattening near term, and then bull steepening (Exhibit 9). In bonds, the bull steepening could be more limited as demand for long-dated bonds stays strong in the rally. This also supports a richening of Buxl vs Bunds on ASW. PFs could turn to buying OTM receivers in long tails, richening these vols, as a trade-off between having to hedge against lower long-end rates ahead of the transition to DC, and avoiding a long-end swaps position that may be redundant post transition.

The March rally, which was followed by rangebound rates and uncertainty around the pension reform (with the law only just passed in May) may have contributed to limited receiving activity from Dutch Pensions since March. The 10s30s and 30s50s curves look c.6-7bp too steep relative to what their relationship vs 2s10s and vol would imply.

Exhibit 1: 10s30s and fair value based on relationship vs vol & 2s10s
Fair value for 10s30s curve is around -53bp, ie. 6bp flatter than market level.



Source: BofA Global Research.

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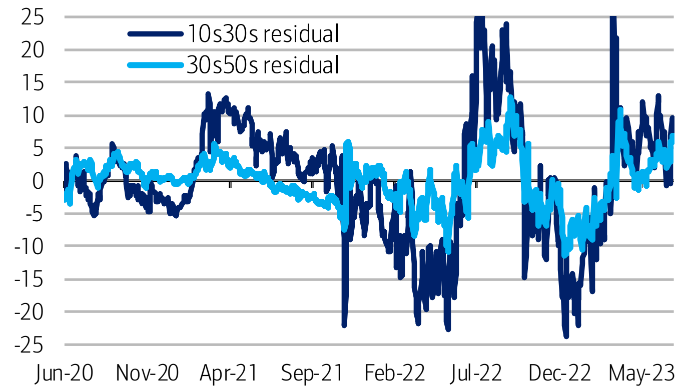
Exhibit 2: Residual of 10s30s and 30s50s vs 2s10s & implied vol
Pension flows could have contributed to the excessive 15bp (and 10bp) in 10s30s and 30s50s flattening resp. late 2022. Now curves too steep.



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More on 5 reasons why indexation impact could be smaller

The impact of the next indexation rounds on the EUR 10s30s swaps curve is likely to be smaller than what was observed in 4Q22-1Q23. Here are more details on the 5 reasons:

1. Inflation over Jul-22 to Jul-23 (most common reference period) is likely to be much lower than the 12.4% registered over Jul-21 to Jul-22. Also, funds had more catch-up to do last year following years of close to 0% indexation (Exhibit 3).
2. Funding ratios have declined due to the Jan-23 indexation (Exhibit 4), reducing somewhat the room for additional large indexation, especially as funds look to keep buffers for the transition to DC. In Exhibit 5, we examine different indexation scenarios and estimate the receiving needs they would create if funds wanted to maintain their interest rate hedge ratios at 1Q23 levels. With 2% indexation, receiving needs could be limited to €15mln/01, while full indexation based on latest inflation print would imply over €40mln/01 of receiving needs.

Exhibit 3: Average Dutch pension indexation for active PF members
Average indexation hovered around 0% for more than a decade

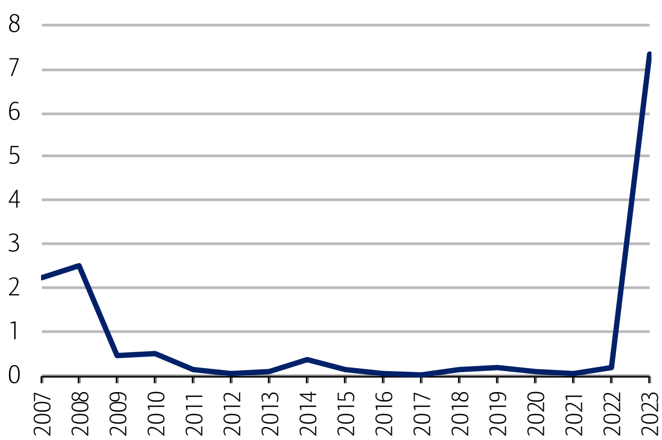

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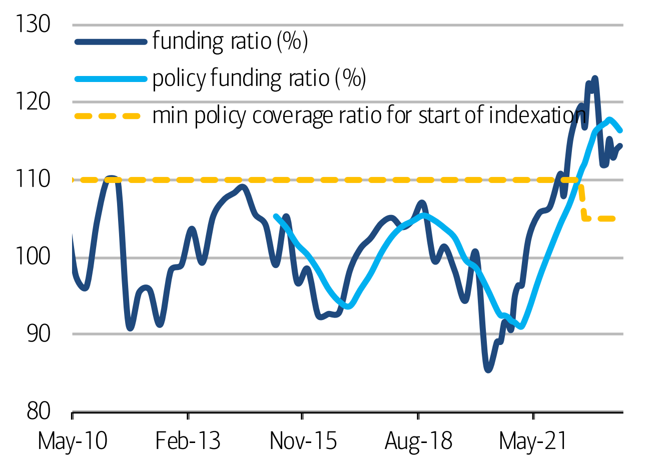
Exhibit 4: Industry Wide Dutch Pension Funds' funding ratios
Dutch PFs funding ratios have surged with the rise in rates in 2021-22



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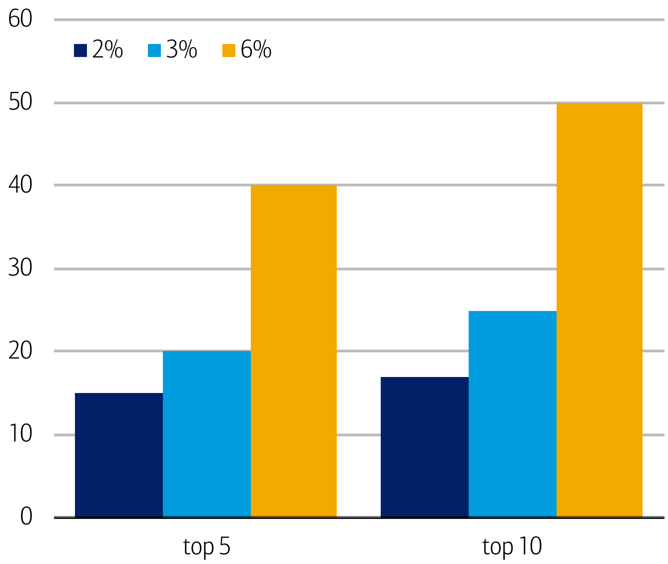
3. In 4Q22-1Q23, most funds didn't just offset the impact of indexation on their interest rate hedge ratios, they went beyond and increased their hedges (Exhibit 6). One could interpret this as a general trend that can extend, given the risks posed by lower rates in coming years. But it could also mean, on the other hand, that they are able to tolerate some decline in the hedge ratios due to indexation.

Exhibit 5: Amount of receiving in mln/01 needed for Dutch PFs to offset impact of indexation on rate hedge ratios (BofA estimates)
We look at 3 indexation scenarios; consider top 5 & top 10 Dutch PF groups



Source: BofA Global Research

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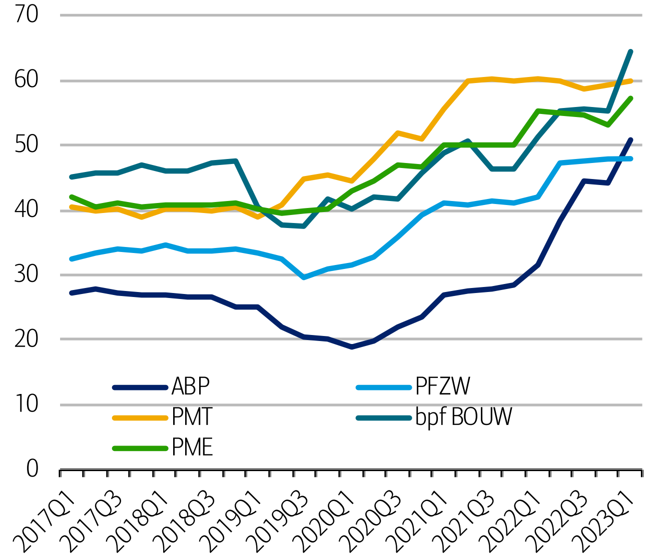
Exhibit 6: Actual hedging of interest risk, for top 5 largest Dutch PFs
Funds have increased their hedge ratios again in 1Q23



Source: DNB, BofA Global Research

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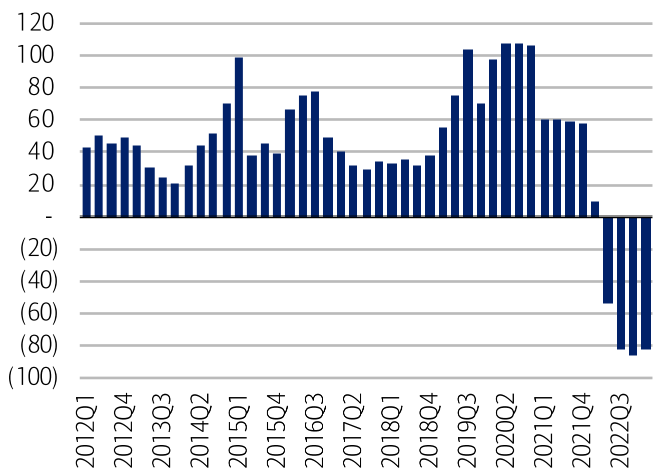
4. More of the duration buying could be done in bonds rather than swaps, as risks around margin requirements are in focus, given the negative valuations on interest rate derivative positions (Exhibit 7). We have already seen increased PF interest in Euro government bond syndications this year relative to prior ones (Exhibit 8).

5. More receiving could be done in shorter maturities, rather than in the 30y+ as funds prepare for the pension reform leading to less receiving needs at long maturities.

Exhibit 7: Market value of Dutch PF interest rates derivatives positions
Value of IR derivatives positions in deeply negative territory post rates selloff



Source: DNB

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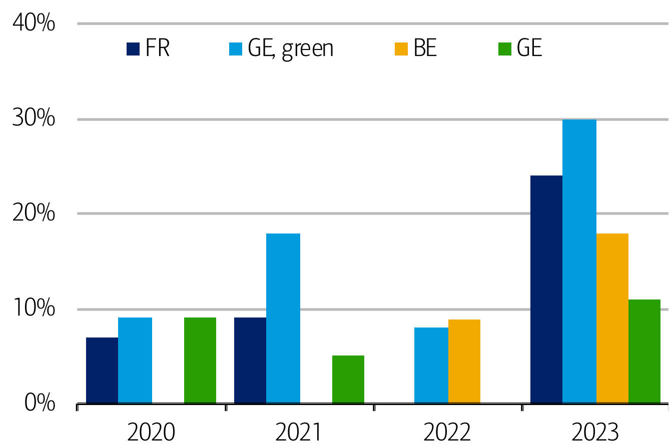
Exhibit 8: Allocation to pension funds (*) at 30y syndications
Pension funds' have absorbed a larger share of syndications in 2023.



Source: debt agencies, BofA Global Research. (*) for German green and conventional syndications, allocation percentages are for Pensions & insurers together.

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Three takeaways on curve, swap spreads and swaptions

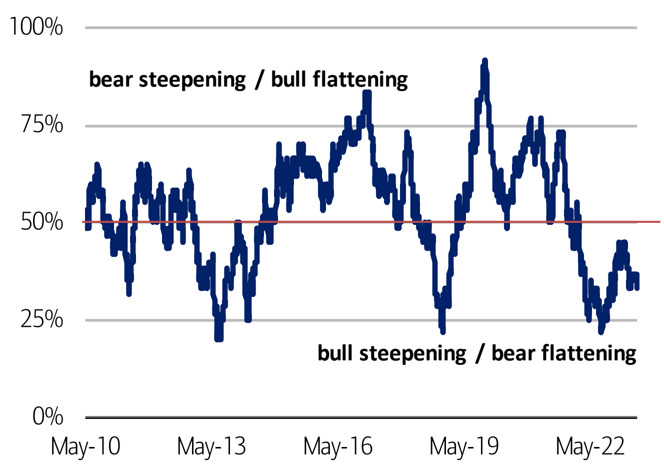
Taking on board the five factors below, we would highlight 3 market implications:

1. The dynamic of the 10s30s swaps curve can remain driven by the 10y (Exhibit 9), with scope for bear flattening near term (especially as 10s30s look too steep vs 2s10s and vol), and then bull steepening when the rally asserts itself.

2. In bonds, the bull steepening could be more limited as demand for long-dated bonds remains strong in the rally. We find it particularly interesting that the German Finanzagentur's Q3 funding update includes a net reduction in bond and bill supply, but an increase in 30y issuance (see European Rates Watch). We believe it is likely to be a reflection of the higher investor demand in that sector. This points to potential for a richening of Buxl vs Bunds on ASW. The relationship between the two has been very stable in Q2, possibly on limited swaps flows, however we see scope for Buxl to trade on a structurally richer level vs Bunds ASW, as was the case pre 2022 (Exhibit 10). Besides long end bond demand by PFs, we could see: (a) greater demand from insurers as well, (b) reduced paying flows in the 10y when the rally asserts itself, and (3) more swapped financial corporate issuance, putting greater tightening pressure on 10y spreads.

3. As funds consider the trade-off between adding swap hedges against lower long-end rates ahead of the transition to DC (to protect funding ratios), and the risk of having to close them post transition under unfavorable conditions (reduced liquidity, same-way market), they could turn to buying OTM receivers in long tails, richening vol in 30y tails vs 10y tails. As the curve dynamic would point otherwise (with 10y rates being more volatile), a more immediate vol expression of this potential PF demand could be a calendar spread: short 6m-1y expiries vs 2-3y ones in 30y tails.

Exhibit 9: % of 10s30s moves driven by the back-end over 3m
Since 2022, moves in the 10s30s curve has been mostly led by the 10y.



Source: BofA Global Research

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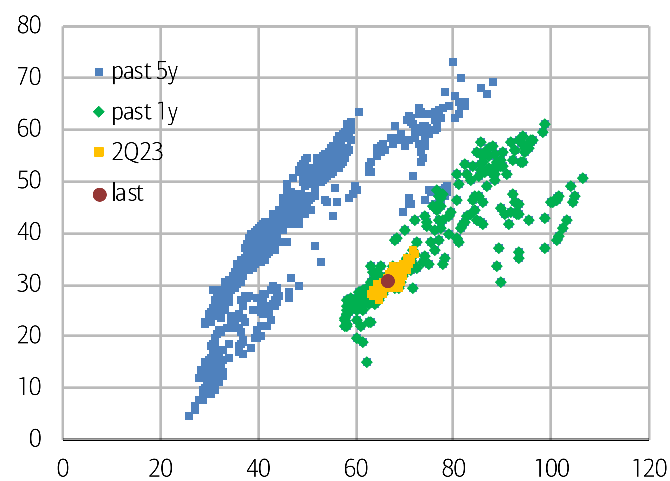
Exhibit 10: Buxl vs Bund Euribor asset swaps
The relationship between the two has been very linear in 2Q23, with scope for Buxl to richen structurally back to the pre 2022 relationship vs Bunds



Source: Bloomberg, BofA Global Research

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