COUNTRY SPOTLIGHT | SWITZERLAND

Travelling towards change

Swiss pension funds may currently be well funded, with a solid saving habit engrained in the population, but controversial measures to stimulate the economy, high conversion rates and an ageing population may dent this security. Louise Farrand **examines the improvements being considered to the current pension system**

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Some pensions challenges are universal. Generally speaking, people are living longer and saving less, whilst hoping to rely on increasingly-stretched state pensions. This poses a problem for many governments all over the world.

However, some countries face more acute difficulties than others. Switzerland's policymakers made two decisions in early 2015 in a bid to stimulate the economy. However, the policy moves simultaneously raised questions about the sustainability of the pensions system.

The first was the Swiss National Bank's removal of the minimum exchange rate of CHF 1.20 to the euro in January 2015, leading to the franc's rapid appreciation against the euro and a sharp drop in its main equity index, the SMI.

The second came in April 2015, when the Swiss Federal Treasury became the first European institution to auction benchmark bonds at a negative yield.

"Many industry commentators at the time argued both could have grave consequences for local pensions, due to the resulting significant drop in the Swiss equity market and negative drag on performance for unhedged foreign investments," State Street head of asset owner solutions and strategic market initiatives, sector solutions EMEA, Oliver Berger says.

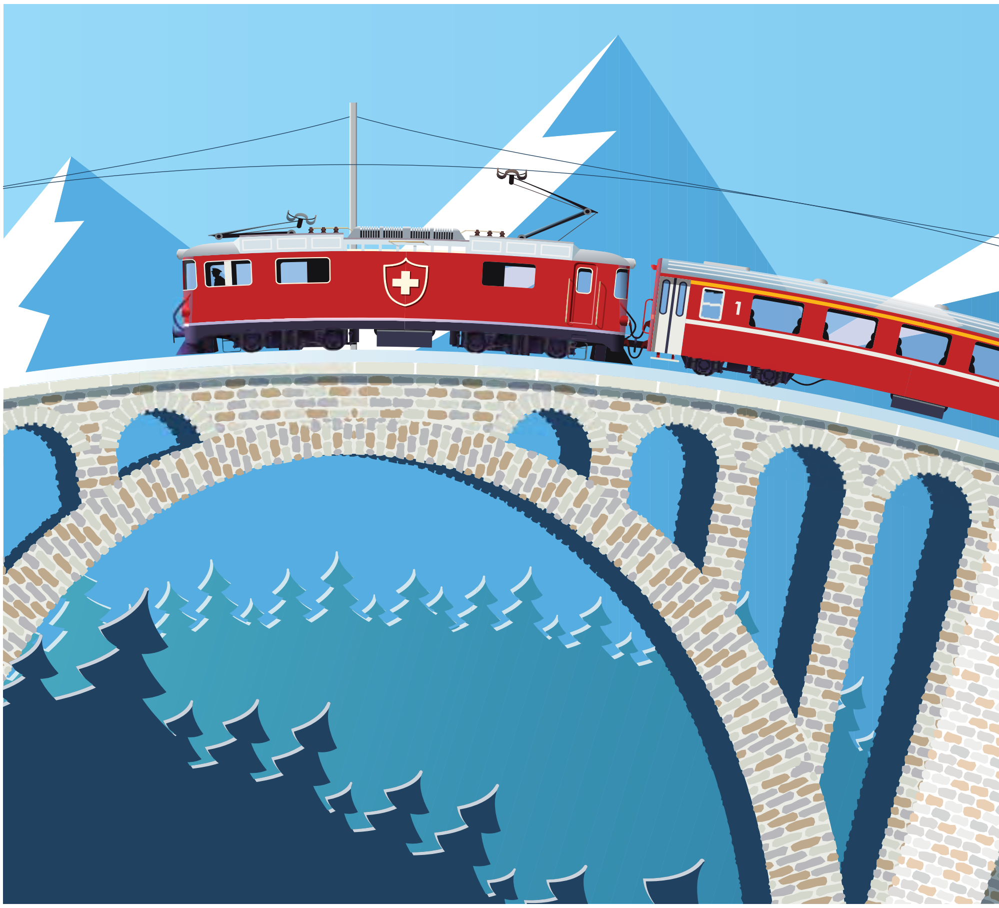
A stretched system

Adding to these problems is the fact that Switzerland's population is ageing fast."According to the OECD, more than a quarter of the economically-active population in Switzerland are aged 65 or over, placing the spotlight fully on pension fund sustainability and the provision of an adequate income in retirement", Berger states.

The imbalance is set to get worse. Switzerland is one of six European countries that is heading towards an old age dependency ratio of above 50 per cent by 2040. That means that there will be less than two people of working age for every retiree, according to the *Melbourne Mercer Global Pension Index 2016*.

Therefore, Swiss occupational pension schemes find themselves under greater pressure than ever to provide for more retirees, with fewer workers contributing to pension pots. Political debate centres on the question of: "How do we distribute the burden of saving more?", as Swiss think tank Avenir Suisse senior fellow and social policy research director Jérôme Cosandey summarises.

Switzerland has a three-pillar pensions system, which consists of a state pension, a workplace pension scheme and a private



pension scheme for those who wish to further bolster their savings. Saving into a workplace pension scheme is compulsory for workers and their employers.

The defined contribution-style arrangement means workers build up a pension pot that is converted into a guaranteed monthly income at the point of retirement, which is usually paid by the pension scheme (retirees can also opt to take their pot as a cash lump sum). A conversion rate is used to calculate the income that pensioners receive.

"The problem we have is that we promise pensions that are too high," Cosandey adds. "The minimum conversion rate of 6.8 per cent assumes life expectancy of 90 years and an annual return of 4 per cent, which we don't have any more. Political reforms aim to reduce the conversion rate down to 6 per cent, which is a step in the right direction but if you talk to actuaries they would say something like 5 to 5.5 per cent would be more appropriate."

"It is controversial to make changes to the conversion rate," Mercer's head of retirement for Switzerland André Tapernoux comments. "Typically, the government would not make changes from one day to the next – they might lower the rate with one year or five years' notice."

Unpopular as it may be among Switzerland's voting public and trade unions, many commentators argue that loweringthe conversion rate is the key to ensuring the long-term viability of the system.

Switzerland's Federal Council has put together a 'Pensions 2020' reform package, which, as Cosandey says, includes reducing the minimum conversion rate of pension funds from 6.8 to 6 per cent. The idea is to increase contribution levels commensurately to account for the reduction in conversion rates, explains Tapernoux.

Many large Swiss pension schemes have already taken the decision to cut conversion rates, unprompted by regulators. Tapernoux cites Credit Suisse as one example.

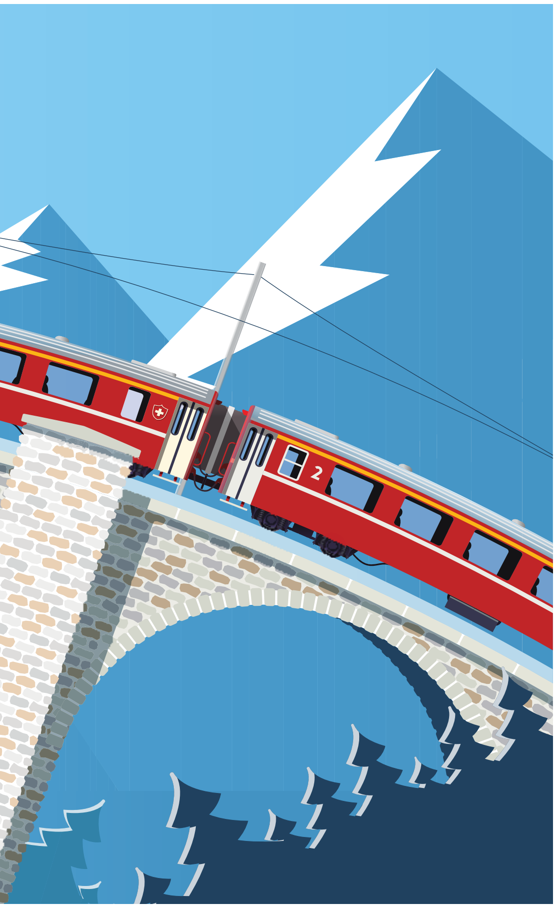
It's a trend Sussex Partners managing director Filippo Montalbano sees again and again, even among relatively-wealthy companies like banks. He uses the example of one bank that has reduced the conversion rate, increased the scheme's retirement age and capped pension income. "I am sure we will see more of this happening – increase the retirement age and decrease the income."

He adds: "For me, pension funds are a ticking bomb in Europe. It's not the fault of central banks. It's the fault of governments, because central bank *[policy is]* just giving time to politicians. It is the job of politicians to change the framework. If they do so, they are not going to be re-elected. This is the whole issue."

Bonded to conservatism

Because Swiss occupational pension schemes must offer a fixed pension to retirees, the vast majority are very well-funded and take a conservative approach to investment.

"The pension fund would be happy to take more risk, but they realise the risk is borne by active members in order to pay the pensions of the retirees. So they don't want to take too much risk.



SWISS PEOPLE MAY BE VERY CONSERVATIVE, BUT THEY ARE WISE ENOUGH TO SEE WHEN CHANGE IS NEEDED

For schemes that are run by insurance companies, it's very important to have a coverage ratio of over 100 per cent or they will lose clients," explains Cosandey.

Willis Towers Watson's 2017 Global Pensions Assets report found that the US, Australia and the UK have higher allocations to equities than is typical among most of the world's other largest pension systems. Meanwhile, Switzerland, Japan and the Netherlands have more conservative investment strategies, with higher allocations to bonds.

Yet the ongoing search for yield is challenging the conservative investment inclinations of most Swiss pension fund chief investment officers (CIOs). "Asset return expectation has been pulled significantly downwards. That is a fundamental challenge. We had the CIO of one of our Swiss clients be very clear that there are only three responses: increase contribution rates, reduce benefits i.e. reduce the conversion rate, or take on more investment risk. Most schemes are looking at all three of those options," says Record Currency Management CEO James Wood-Collins.

Wood-Collins' colleague Jan Witte, who is Record's director of quantitative research, adds: "We see an uptick in interest in, maybe not yet what is seen as riskier assets, but certainly less-liquid assets."

As investment returns are low, the focus has turned towards value for money. Schemes have been cutting their costs and moving towards passive investments in recent years, explains Montalbano

Simultaneously, the ongoing uncertainty within global markets means they are willing to spend more on longer-term and more illiquid investments with potentially lower volatility, like infrastructure and private debt.

The latter offers bond-like returns, Montalbano underlines. "Often pension scheme investors also look for coupons; depending on how you structure it, they can get a quarterly coupon."

Berger echoes Montalbano's view: "As pensions become increasingly focused on finding higher-yielding assets, and feel more comfortable with complex asset classes such as alternatives, a natural trend toward such investments will likely emerge. For example, Swiss pension funds interviewed in our research stated that over the next year they would increase their allocation to hedge funds (single manager), infrastructure and private equity by 78, 52 and 70 per cent respectively."

Schemes are likely to consolidate, in order to access alternative asset classes, Montalbano and Berger emphasise. The latter reports: "Our research found 63 per cent of Swiss pensions intend to consolidate multiple retirement plans within the next three years; as nearly a fifth (19 per cent) felt the greatest benefit of this to be reduced costs. All of which is understandable given 30 per cent strongly believe they are under pressure to cut costs."

Despite the unequivocal challenges the Swiss pension system faces, there are reasons to be cheerful. The government is acting to reduce today's unsustainable conversion rates and improve contribution levels. The country's compulsory occupational pensions system means that the savings habit is ingrained already, putting it ahead of voluntary second pillar systems like the UK's.

Melbourne Mercer's 2016 Global Pensions Index gave Switzerland's pensions system a solid B grade, ranking it alongside Canada, Finland and Sweden, among others.

A 2015 *Financial Times* piece declared that Swiss pension schemes could be bankrupt within 10 years. Montalbano is doubtful. "The advantage of being a small country is that if something is really dangerous, you can react quite fast. Swiss people may be very conservative, but they are wise enough to see when change is needed." ■