COUNTRY SPOTLIGHT SWITZERLAND

Up in the air

Switzerland's pension reform legislation is once again likely to be amended due to governmental changes. Peter Davy **explores the reasons why and analyses the state of the Swiss bond market**

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There will be no quick fixes for Swiss pensions. Following the elections last October, the future of the pensions reform legislation Altersvorsorge 2020 (Retirement 2020 or AV2020) is once again up in the air.

The elections saw a swing to the right, giving the conservative Swiss People's Party (SVP) the largest share of the vote and seats in the country's lower (and larger) parliamentary house, the Nationalrat (National Council). The economically right-wing Liberal Party (FDP) also saw gains.

This brings a number of potential problems to the forefront. First, the right-leaning MPs may be tempted to introduce changes such as increasing the retirement age, reducing the prospects of cross-party consensus; a survey after the election by newspaper *Basler Zeitung* found over 80 per cent of conservative MPs favoured a retirement age of 67 (as opposed to 65).

Second, the lower house is now more likely to overturn amendments to the proposals introduced before the election by the upper house, the Ständerat. Most notably, it has proposed an increase to the first pillar of CHF70 (€63.95) a month, designed to compensate for cuts to minimum conversion rate (which is used to calculate the pension members receive from their pensions savings) in the second pillar.

"They argue it will help pass the reform because people will see the benefit of more money coming from the first pillar. On the other hand, it increases the financial burden on a time when we need to be careful to live within our means," Swiss thinktank Avenir Suisse researcher Jérôme Cosandey explains.

Both houses are also working to a deadline: the proposals are partly financed by an increase in VAT, which includes a temporary component of 0.3 that expires at the start of 2018. A referendum is needed by May 2017 to maintain this and use it for pensions.

"If everything goes smoothly the second chamber will make its amendments and then the first chamber has to approve that. We cannot allow a lot of ping-pong, though, because it is a very tight schedule – one of the tightest we have," Cosandey states.

Effectively, both houses must pass the proposals by the end of this year or early next.

The big question for Swiss Association of Actuaries (SAV)

THE SWISS SYSTEM OF GOVERNANCE HAS A LOT OF BENEFITS BUT DEALING WITH CHANGE IS PROBABLY NOT A STRENGTH

president Klemens Binswanger is whether the reform passes as a package or if interest groups will try to split it into several smaller issues. If the latter, the negotiations could go on for years.

Ever deeper: low yield persist

As it is, even if passed in 2018, the changes will be introduced gradually, becoming fully implemented by 2024, Cosandey estimates. The challenges faced by second pillar funds are somewhat more immediate, however.

Low interest rates of recent years present a significant problem for funds that grew used to relying on high yields in previous decades.

"That is probably one of the reasons why we have such a problem today because people thought we have high yields so we don't have to worry about the higher life expectancy," says Binswanger. "As interest rates are now very low, however, they can no longer cover the costs of longevity."

How well this is recognised is open to question. Part of the problem, PPCmetrics partner Hansruedi Scherer suggests, is that the current technical interest rate used by Swiss pensions to calculate their coverage rates is, in most cases, well above the yields on long-term government bonds, which are negative (-0.23 per cent for 10-year government bonds).

"Using a market rate to calculate the liabilities rather than the technical interest rate gives you much lower figures," Scherer states.

The problem is not so much current coverage ratios, he says, but that pension fund boards continue to make decisions on the basis of the distorted view that the technical coverage ratio paints.

"The single decision is not the problem but they continue to make poor decisions and the sum of all these will mount up to a serious problem in the long term," he explains.

That is changing, however. While 2014 and the start of 2015 produced fair returns for a traditional Swiss pension fund portfolio invested in domestic bonds and equities, that changed later in the year. The Credit Suisse Pension Fund Index saw a decline of 2.21 per cent in August, and fell a further 0.93 per cent in September, wiping out gains from earlier in the year.

"The fact that Swiss government bonds are not very attractive hasn't changed but the current situation forces people to think about it even harder," Swiss investment advisory firm Siglo partner Christoph Gort comments. "Last year the excuse was that returns were still fine so they could just wait, but for 2015 the returns have not been good and that might wake up even more people."

There are two possible scenarios for Swiss bonds, Aon head of investment consulting in Switzerland Dominique Grandchamp says. Neither looks good for those with heavy investments in Swiss sovereign or investment grade corporate bonds.

First, Switzerland moves towards a Japanese-like environment and low rates persist indefinitely: "In that case you can expect your total return on these assets to move sideways and therefore actually the net return that includes your liabilities will be negative. That might slowly eat up capital, thereby putting pressure on the funding ratio," he says.

The second scenario is that Swiss bond yields start to increase, led by the US.

"That would mean, if interest rates increase above what is already priced into the bonds, you have short to mid term unrealised capital losses."

(Over a longer time horizon, of course, the higher-yielding bonds will replace lower-yielding ones reaching maturity and the total return of the asset class will turn positive again, he adds.)

Not surprisingly, many advocate big moves away from traditional bond portfolios.

"Funds need to diversify to avoid plain bonds," Mercer principal Christophe Steiger explains. "I believe plain bonds should be almost abandoned."

Going everywhere

That, however, is the easy part. The hard part is finding a replacement. There is no obvious solution.

Seeking greater yields in foreign sovereigns, for example, is challenging due to the exchange rate, with the Swiss franc stubbornly strong. "You might look at US Treasuries because they offer a better interest rate than Swiss bonds, but at the end of the day the costs of hedging the currency mean you do not get a great advantage," Unigestion head of cross asset solutions Jerome Teiletche states.

Instead, funds are not only adding to already significant allocations to Swiss real estate but also looking at the illiquidity premium – considering private equity and debt, infrastructure, and insurance-linked securities. There's also some work being done on liquid alternatives, says Stefan Haab, who runs Pictet Asset Management's institutional relationship team in Zurich.

"They are trying to achieve bond-like returns – that is, bond returns as they were in the good old days rather than in today's environment – along with bond-like risk profiles," he explains.

Progress is slower than it could be, however, in part because of the many small and mid-sized schemes that rely heavily on their trustees and do not have full-time executive staff.

"It is difficult to familiarise yourself with insurance-linked securites, for instance, if you have maybe one day a month for the pension fund," Haab outlines. "The Swiss system of governance has a lot of benefits but dealing with change is probably not a strength."

Nevertheless, there has been a gradual widening of the asset classes featuring in Swiss funds' portfolios. While some are still heavily invested in traditional bonds with 50 or even 60 per cent allocations; others have moved extensively to alternatives, Steiger emphasises.

"There used to be five or six asset classes in Swiss pension funds; now it is more like 10 or 15."

This is a move in the right direction, but it won't be enough, Gort says.

"There is one scenario where everything is fine for Swiss pensions, and that is when equities grow 10 per cent or more an annum. Then everything is okay," he says.

"In every other realistic scenario they will have a hard time to meet the target return."

That means looking at the liabilities as well, either cutting benefits, increasing retirement ages, or increasing sponsors contributions – and an increasing number of funds have already lowered the conversion rate.

For many others, however, there are hard choices ahead. ■

"CHF 71 billion of Swiss funds (are) currently managed with some kind of ESG investment"

Turning to ESG

ANOTHER AREA OF CHANGE for Swiss pensions is environmental, social and corporate governance (ESG). December saw the creation of the Swiss Association for Responsible Investments (SVVK-ASIR) by the first pillar AHV fund, the accident insurance fund Suva, and five of the largest second pillar funds. Between them, they manage over CHF150 billion (€137 billion).

The group allows the funds to develop common criteria and definitions for ESG, according to Publica deputy CIO Patrick Uelfeti.

"We saw that we all faced the same questions and it would be beneficial to everybody if we cooperated, rather than each tried to go our own way and address the same issues repeatedly," Uelfeti says, who is also president of the new association.

ESG is not new in Switzerland. Ethos, the first socially responsible investment group in Switzerland was established 18 years ago, and today has 214 members who are pension funds. It goes far further in its screening of investments than SVVK-ASIR, according to its chairman Dominique Biedermann – and not only excludes unethical stocks, but also offers engages with companies through exercising shareholder voting rights.

ESG is growing in importance, says Biedermann, with CHF 71 billion of Swiss funds currently managed with some kind of ESG investment, according to FNG, the German, Austrian and Swiss Sustainable Investment Forum.

Neverthless, Uelfeti says ESG development in Switzerland still lags some other European countries when it comes to pressure from the scheme members or public policy through legislation.

That's the experience at comPlan, the another of the founding members. Its board started looking at ESG issues last year. Pressure to do so came not from members, but from the plan sponsor, telecommunications company Swisscom.

"It's not individual members, but more a result of thinking about consistency in the action of the plan and the plan sponsor," the fund's head of asset management Roman Denkinger comments.