Investment Consulting

European Pension Fund Investment Forum

Pension Fund Governance
Where do we go from here?

PPCmetrics AG
Lukas Riesen, CFA, Senior Consultant

Zurich, 4 December 2012

Perspective of a Beneficiary

Should I pay additional contributions into my pension fund retirement account?

Yes, if the pension fund …

- is **trustworthy** and adheres to **checks and balances**
- is **transparent** and discloses **information publicly**
- offers an attractive **risk-return-profile** for my investments

and if …

- tax-benefits are attractive

Good Pension Fund Governance

- Basically, good governance can be seen as **etiquette**

- Good governance mitigates the **principal-agent problem**
  - beneficiary (principal) has less information and power of control
  - pension fund (agent) acts on behalf of the beneficiaries

- Seek **confidence of beneficiaries** by considering
  1. **Organizational structure**
  2. **Information**
  3. **Risk management**

1: Organizational Structure

- Establish **checks and balances** by separating
  - **Decision** *(e.g. board of trustees)*
  - **Implementation** *(e.g. portfolio manager)*
  - **Control** *(e.g. investment controller)*

- Establish **well-balanced committees** with **low turn-over**

- Avoid **conflict of interest** and establish a **culture of loyalty**

- Avoid **principal-agent problems** within organization
  (*e.g. asymmetric information between portfolio mgr. and board)*

1: Organizational Structure (cont.)

- **Demand same results** from internal and external managers
  - measure with same yardstick
  - take action if internal mandates underperform
  - be aware that there is no corporate liability for internal managers
- **Call for bids** when engaging managers and **keep records** for all mandates
- Choose the most **efficient structure** to lower costs

Most Swiss pension funds already act accordingly.

2: Information

- Publish relevant **information on a website**
  - organizational charts, plan rules and annual reports
  - investment strategy and achieved performance
  - **key figures** to assess the financial situation of the plan and figures that can be compared with other pension plans

Most Swiss pension funds publish data publicly.
However, figures lack transparency and comparability.

- We propose to introduce the **risk carrying funding ratio**
  - indicates the burden on risk bearers (**transparency**)
  - **comparisons** between pension funds can be drawn

2: Computing the Risk Carrying Funding Ratio

ppc metrics

1st step: Compute assets of active members

total plan assets

Liabilities to retirees
(actuarial valuation)

reappraisal
(fair value)

Liabilities to retirees
(fair value)

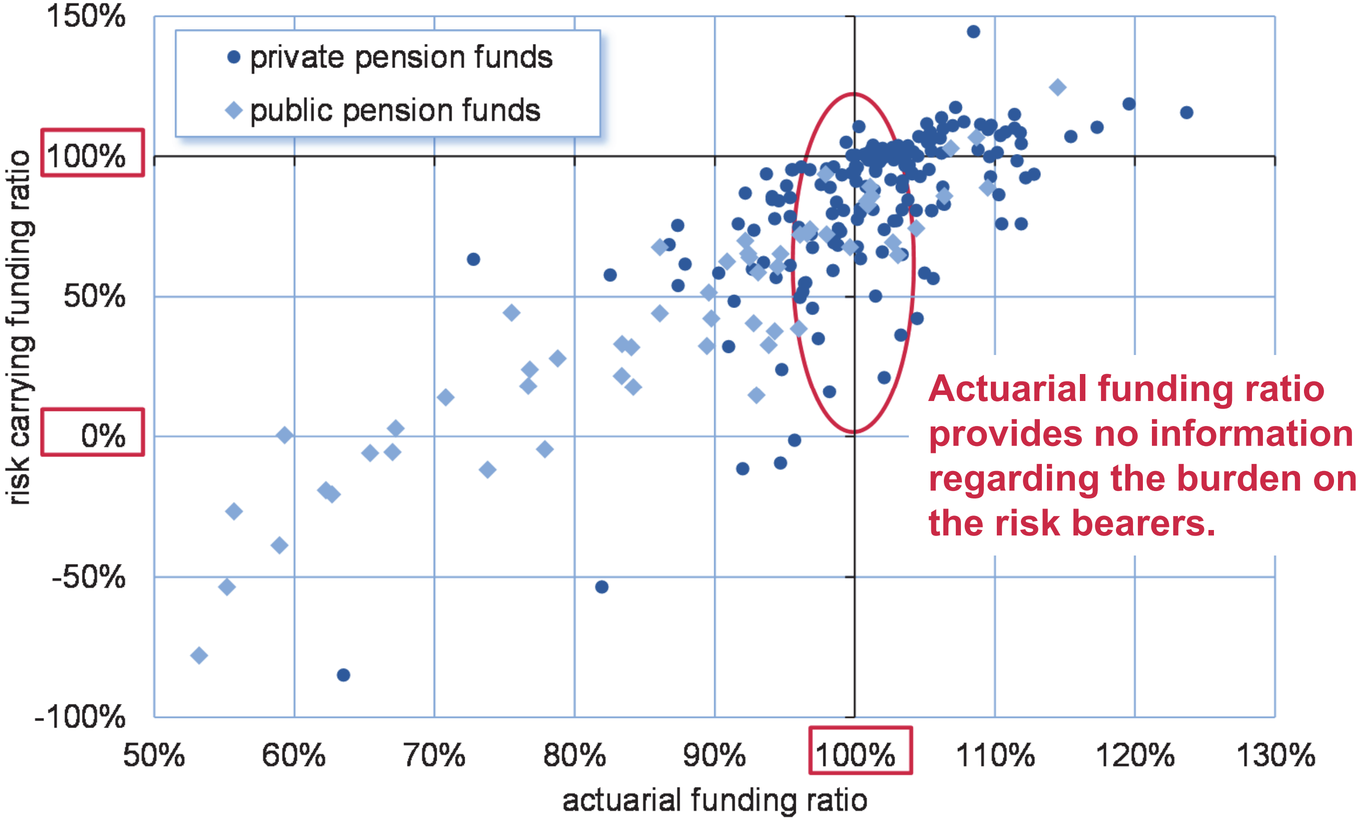
plan assets
active members

2nd step: Compute funding of vested benefits

$$\text{risk carrying funding ratio} = \frac{\text{plan assets active members}}{\text{vested benefits}}$$

2: Current Situation in Switzerland

Comparison of funding ratios based on annual statement 2011



Calculations: PPCmetrics; source: www.deckungsgrad.ch; as at: 06.11.2012

Data from 236 Swiss pension funds with total assets of CHF 440 bn

2: Risk carrying funding ratio

- Improves **information about financial situation** of pension fund and allows **comparisons**

- Serves as a measure regarding **burden on risk bearers** *(e.g. How safe are my assets, if a partial liquidation combined with a reduction of the actuarial interest rate takes place?)*

- But, risk carrying funding ratio does not indicate burden sharing
  - between risk bearers (active members, employer, tax payer)
  - over time (old, young or future members)

Should I pay in? Depends on risk carrying funding ratio.

3: Risk management

- Investment strategy has to be based on **ALM** (art. 50 LPP 2) and implementation is mainly a question of **organization**

Most pension funds adhere to that principle.
However, does the pension funds investment risk suit my risk preference and do I get an adequate return?

- Good governance requires risk-return to be in adequate relation
- Risk-return of pension plan are just one side of coin

Portfolio returns	BVG 25	BVG 40
Last 10 years p.a.	3.8%	4.0%
Last 5 years p.a.	1.7%	0.2%
expected return p.a. *	2.1%	2.7%

** based on an equity risk premium of 4.0%*

3: What is leftover for active members?

- Other side of coin is how returns are (can be) distributed

Balance sheet in milions of CHF	**Plan A**	**Plan B**
Vested benefits	30	70
Liabilities to retirees *Actuarial interest rate / mortality table*	70 *3.5% / PT*	30 *1.5% / GT*
Total plan assets	100	100
Return distribution		
Investment return 4.0%	4.00	4.00
./. required return retirees and 0.2 mgmt costs	3.00	0.65
Residual active members *in % of vested benefits*	1.00 *3.3%*	3.35 *4.8%*
Residual active members (in %) other return scenarios		
Investment return 3.0%	*0.0%*	*3.4%*
Expected return 2.1% (BVG 25)	*-3.0%*	*2.1%*

3: Distribution of Returns

Should I pay in? Plan A: Most probably not. Plan B: Maybe.

- Improve transparency by informing beneficiaries about
  - **current return distribution**
  - **forecasted return distribution** based on certain scenarios

- If risk-return relation for beneficiaries is not adequate, good governance requires a pension fund to
  - **inform transparently**
  - take all possible and necessary steps to **improve the situation**

Concluding Remarks

- Most Swiss pension funds **adhere to best governance standards** regarding organization and general information

- **Room for improvement** lies in the **quality of information**
  - financial situation of the pension fund
  - current and forecasted return distribution for beneficiaries

- To foster **transparency** and **comparability** we propose to introduce the **risk carrying funding ratio**

- Timely and comprehensive information is basis for **seeking confidence** of beneficiaries