European Pension Fund Investment Forum

Pension Fund Governance
Where do we go from here?

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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

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

1st step: Compute assets of active members

- Total plan assets
- Liabilities to retirees (actuarial valuation)
- Reappraisal (fair value)

2nd step: Compute funding of vested benefits

- 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

Actuarial funding ratio provides no information regarding the burden on the risk bearers.

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.

<table>
<thead>
<tr>
<th>Portfolio returns</th>
<th>BVG 25</th>
<th>BVG 40</th>
</tr>
</thead>
<tbody>
<tr>
<td>Last 10 years p.a.</td>
<td>3.8%</td>
<td>4.0%</td>
</tr>
<tr>
<td>Last 5 years p.a.</td>
<td>1.7%</td>
<td>0.2%</td>
</tr>
<tr>
<td>expected return p.a. *</td>
<td>2.1%</td>
<td>2.7%</td>
</tr>
</tbody>
</table>

*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 millions of CHF

<table>
<thead>
<tr>
<th></th>
<th>Plan A</th>
<th>Plan B</th>
</tr>
</thead>
<tbody>
<tr>
<td>Vested benefits</td>
<td>30</td>
<td>70</td>
</tr>
<tr>
<td>Liabilities to retirees</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Actuarial interest rate / mortality table</td>
<td>3.5% / PT</td>
<td>1.5% / GT</td>
</tr>
<tr>
<td>Total plan assets</td>
<td>100</td>
<td>100</td>
</tr>
</tbody>
</table>

### Return distribution

<table>
<thead>
<tr>
<th></th>
<th>Plan A</th>
<th>Plan B</th>
</tr>
</thead>
<tbody>
<tr>
<td>Investment return 4.0%</td>
<td>4.00</td>
<td>4.00</td>
</tr>
<tr>
<td>./ required return retirees and 0.2 mgmt costs</td>
<td>3.00</td>
<td>0.65</td>
</tr>
<tr>
<td>Residual active members</td>
<td>1.00</td>
<td>3.35</td>
</tr>
<tr>
<td>in % of vested benefits</td>
<td>3.3%</td>
<td>4.8%</td>
</tr>
</tbody>
</table>

### Residual active members (in %) other return scenarios

<table>
<thead>
<tr>
<th></th>
<th>Plan A</th>
<th>Plan B</th>
</tr>
</thead>
<tbody>
<tr>
<td>Investment return 3.0%</td>
<td>0.0%</td>
<td>3.4%</td>
</tr>
<tr>
<td>Expected return 2.1% (BVG 25)</td>
<td>-3.0%</td>
<td>2.1%</td>
</tr>
</tbody>
</table>
3: Distribution of Returns


- 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.