Global Pension Risk Survey 2015

Swiss Survey Findings
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Introduction

Pension risk management in Switzerland is undergoing a significant change. With better tools, information, and higher requirements from the regulator (OAK), pension funds are now taking more active control of risk management. One key finding of this survey is however, that there is still room for improvement and broader coverage of all risks a Swiss pension fund is confronted with.

In this report we identify the risks that are of most concern to pension fund managers, trustees, and sponsors, and how these risks are being assessed. We also explore how pension fund risks are being mitigated, transferred or retained.

As the respondents to our survey largely operate single-employer pension funds, the responses primarily reflect situations where risk has been retained rather than transferred to a fully-insured Collective fund.

Our survey did not cover risks relating to the design of the benefits in meeting the needs of employees, but focuses on the financial and operational risks of managing a Swiss pension fund once the benefit target level have been defined.

Most Swiss pension funds indicate that their long-term objective is to fully build up their investment fluctuation reserves. Nearly half the surveyed pension funds state that they intend to attain this objective in a time-frame of 1 to 5 years. According to our Survey, pension funds see long-term low yield environment interest rates and volatility of return on investments as the main factors determining whether or not they will reach this objective.

Low yield environment, longevity, investment returns and generational cross-subsidy are the risks that most concern respondents, but operational risks relating to a lack of time, high volumes of work due to increasing regulatory requirements, and a lack of resources were highlighted as significant barriers to managing these risks.

The responses indicated a desire to:

• De-risk – though there are strong concerns that the price of risk transfer
• Delegate – with many aspects of asset selection already delegated, and desire for more
• Diversify – a trend can be seen in the broadening of investment classes

The same survey was carried out globally. Please let us know if you would like to study the report for any other country, or the global summary report.

Best regards,
Aon Switzerland Ltd
How Switzerland differs to other countries in our survey

Our survey covered sponsors, managers and trustees of pension funds in the countries with the largest volumes of funded pension promises from employers to employees: US; Canada; UK; Netherlands, Ireland, as well as Switzerland.

The pension management challenges differ between these countries due to different legislation, traditions and innovations. However, our survey revealed significant commonality in the aims and directions of travel.

Delegation, Diversification and De-risking are clear common themes. The approaches being taken, and the speed of progress in these directions differ.

Delegation
Switzerland covers both extremes in relation to delegation – all and nothing.

Switzerland and the Netherlands have made the greatest progress delegating implementation responsibilities through wide use of multi-employer funds.

However, Swiss single-employer funds tend to have more in-house management than is common in similar sized businesses elsewhere, and has not yet followed the strongly developing trend in the US and UK towards delegating investment management implementation. However, Swiss pension fund are focusing more and more on investments costs and there is a growing interest to reduce these costs.

Diversification
Swiss portfolios have diversified in recent years, but still remain narrow compared to many other countries.

Alternative asset strategies have started to grow more strongly in other countries, in particular the US and UK, where focus has increasingly moved towards Absolute Return. A wider range of debt investments, and asset classes are being included in pension fund portfolios, rather than restricting to the traditional investment grade bonds, listed equities and property.

There remains significant opportunity to add returns without adding risk. As indicated earlier, we calculate and opportunity to add 0.5% returns pa to the average Swiss pension fund.

De-risking
The requirement to provide promised interest credits and annuity conversion terms, for most employees, differentiates Switzerland from most countries. Swiss employers are not able to use pure Defined Contribution benefit designs - the core approach to de-risking in most countries.

Whilst some employers are more and more investigating the opportunity to pass investments risks to their higher earners through so called 1e plans, this trend has been slower than elsewhere in the world.

The Collective market illustrates a big divide in de-risking longevity and investment risks. Whilst there has been an acceleration of employers choosing insured Collective funds, the majority of employers have chosen to retain these risks whether in a Collective or single-employer fund.

For those that have retained the risks, there has been less attempt to reduce or remove these risks partially. This contrasts with the strong investment and longevity de-risking paths and actions developed by single-employer funds in some other countries.

Although some de-risking benefit design adjustments have been made over last years, Swiss employers have mainly retained all risks or removed all risks – all or nothing. Nevertheless Swiss pension fund sponsors reporting under international accounting standards are looking more closely at their pension funds.
The 2015 Aon Hewitt Global Pension Risk Survey in Switzerland covers over 70 pension funds with more than 460,000 members and total assets in excess of CHF 140bn. The Survey was conducted in January 2015.

The respondents of the Survey were mainly pension fund managers, followed by professionals in other specialist positions.

In terms of plan size, the distribution was well-balanced. Both large and small pension funds participated in the Survey.

The following distribution chart shows statutory funding level on the horizontal axis, i.e. pension assets divided by Swiss pension liabilities and, on the vertical axis, plan size in terms of total assets (as a logarithmic scale). The graph evidences the absence of a relationship or linear correspondence between plan size and funding status in Switzerland.

Based on local funding requirements in Switzerland
Most respondents have similar opinions of the main risks that exist in managing their pension funds. The key risks identified were unsurprisingly:

- **Longevity** – concerns that social and medical improvements will continue to increase the period over which pension commitments must be paid – the new mortality tables that will be published at the end of 2015 will likely confirm this risk.
- **Investment returns** – concerns about continuing to achieve a return at least in line with the statutory interest credits, particularly in the current very low interest rate environment.
- **Generational cross-subsidy** – concerns for the current active population that interest credits will need to be held down to finance growing pensioner liabilities and that the conversion terms for future retirements will need to be less generous than those current pensioners benefited from.

There was very little difference in these opinions by size of fund, funding level or role of respondent. However, pensions managers were the most concerned about investment returns, and those who described their role as Other (not Pensions manager, sponsor or trustee) tended not to answer this question.

The rest of this report looks at the ways in which survey respondents are managing or removing these risks. Other questions in the survey reveal that operational risks, particularly relating to time availability, increasing complexity of the regulatory environment and resources also concern survey respondents.

We don’t explicitly explore political and regulatory risk further, as the opportunities to manage or remove these risks are much more limited.
**Risk Monitoring & Measurement**

Whilst simple qualitative measures remain common, the trend continues towards greater focus on quantitative measurement of risk, with measurement of volatility and Value at Risk (VaR) quickly becoming a normal part of risk governance.

Most risk measurement relates to investment risks, with very little explicit monitoring of longevity or cross-subsidy risk other than as a subset of monitoring funding levels. It is not clear whether this reflects the slower speed of materialisation of these risks, or simply the ease of access to information about investment performance.

The vast majority of respondents monitor asset values and investment performance at least once a month. As our sample reflects more mid- and large-sized pension funds this frequency may differ for smaller pension funds where quarterly monitoring seems still pre-dominant.

This confirms the expectation that there is ready access to information about asset performance for all sizes of pension funds.

However, it is not clear how often this information leads to an action to reduce risk or capitalise on outperformance by making asset class switches. The limited traditional market solutions and the natural reluctance to explore new alternatives are probably a barrier which would not exist when delegating investment management would be broadly implemented.

Interestingly, whilst VaR (slightly) remains the least common measurement, approximately half of respondents who do carry out VaR analyses do so much more frequently than any other form of risk analysis. The growth in frequency of use of VaR may reflect its use within sponsor companies as the measure of impact of a risk materialising in the coming year.

### Measurement of risk tolerance/capability

<table>
<thead>
<tr>
<th>Method</th>
<th>Percentage</th>
</tr>
</thead>
<tbody>
<tr>
<td>Quantitatively - Volatility on asset return</td>
<td>85%</td>
</tr>
<tr>
<td>Qualitatively (eg. Low, medium, high)</td>
<td>62%</td>
</tr>
<tr>
<td>Quantitatively - Volatility on funded status</td>
<td>79%</td>
</tr>
<tr>
<td>Quantitatively - Value at Risk on asset return</td>
<td>54%</td>
</tr>
<tr>
<td>Quantitatively - Value at Risk on funded status</td>
<td>46%</td>
</tr>
<tr>
<td>Quantitatively - Other</td>
<td>17%</td>
</tr>
<tr>
<td>We don't</td>
<td>9%</td>
</tr>
</tbody>
</table>
 Naturally, ALMs are the core analysis, typically carried out every three years – but almost one in five carry out this analysis annually. Nearly all of those who do this annually made changes to their assets holdings in the last year – though very few of these respondents expect to make further asset changes in the coming year.

Given the limited market solutions at the moment, it is not surprising that very few respondents monitor the cost of buying out pensioner liabilities. It is perhaps more interesting that as many as 30% of respondents do monitor this from time to time, indicating a potential demand beyond current market supply, or at least beyond the terms currently available in the market for removing this risk. The insurance market continues to evolve with longevity swaps having become reasonably common ways of removing longevity risk in some other countries. The reinsurance market that supports these swaps operates globally, so a real potential exists for these solutions in Switzerland.

**Measuring and monitoring pension risk**

<table>
<thead>
<tr>
<th>Metric</th>
<th>Weekly or more frequent</th>
<th>Monthly</th>
<th>Quarterly</th>
<th>Annually or less frequent</th>
</tr>
</thead>
<tbody>
<tr>
<td>Asset values and investment performance</td>
<td>11%</td>
<td>43%</td>
<td>46%</td>
<td>1%</td>
</tr>
<tr>
<td>Funding level (technical provisions)</td>
<td>26%</td>
<td>38%</td>
<td>38%</td>
<td>2%</td>
</tr>
<tr>
<td>Funding level (long term basis)</td>
<td>51%</td>
<td>26%</td>
<td>20%</td>
<td>3%</td>
</tr>
<tr>
<td>Covenant of the sponsor(s)</td>
<td>43%</td>
<td>43%</td>
<td>23%</td>
<td>2%</td>
</tr>
<tr>
<td>Cost of potential buyout (transfer of retirees to an insurer)</td>
<td>23%</td>
<td>23%</td>
<td>23%</td>
<td>2%</td>
</tr>
</tbody>
</table>
Despite sponsor insolvency not being named by any respondents as a major risk that concerns them, around three-quarters of funds do regularly monitor the continuing ability of the sponsoring employer to support the fund. Business insolvencies are of course low likelihood, and if the funding is strong have limited impact on the fund - provided that the funding assumptions realistically reflect the lower risk strategy that the trustees would likely need to adopt without a sponsor available to cover arising losses.

Around three-quarters of respondents are targeting a low-risk target or self-sufficient funding, perhaps further reflecting awareness of the risk of the sponsor not be available at some point during the long time period until all pensions have been paid. Almost two-thirds of these funds wish to get to this level of comfort within 5 years – provided long-term interest rates are favourable.
Hedging has become the core to investment risk management in various countries, but in Switzerland there is currently little interest in hedging with one type of exception. Around three-quarters of respondents prefer to hedge currency risks, provided the terms are reasonable.

This is not surprising given the emphasis on hedging from OPP2 regulation and given the Swiss Franc is considered as a safe haven currency. However, we believe that a significant amount of currency hedging takes place with unnecessarily high implicit transaction costs – low explicit transaction costs, and large pricing spread. The frequency of currency hedge revisions means that many pension funds could be paying very significant costs without full visibility of these costs.

Note that our survey closed on 15 January 2015, so the results do not indicate whether attitudes to hedging currency or interest rates changed as a result of the Swiss National Bank’s decision on that day to unpeg from the Euro.

### Attitude to hedging

<table>
<thead>
<tr>
<th>Risk</th>
<th>Option 1</th>
<th>Option 2</th>
<th>Option 3</th>
<th>Option 4</th>
<th>Option 5</th>
</tr>
</thead>
<tbody>
<tr>
<td>Inflation</td>
<td>47%</td>
<td>5%</td>
<td>2%</td>
<td>2%</td>
<td>38%</td>
</tr>
<tr>
<td>Interest rates</td>
<td>45%</td>
<td>11%</td>
<td>2%</td>
<td>35%</td>
<td>38%</td>
</tr>
<tr>
<td>Credit spreads</td>
<td>49%</td>
<td>2%</td>
<td>5%</td>
<td>11%</td>
<td>38%</td>
</tr>
<tr>
<td>Currency</td>
<td>44%</td>
<td>11%</td>
<td>2%</td>
<td>29%</td>
<td>33%</td>
</tr>
<tr>
<td>Longevity</td>
<td>16%</td>
<td>22%</td>
<td>2%</td>
<td>24%</td>
<td>33%</td>
</tr>
</tbody>
</table>

However, 75% of respondents either already take account of the fund’s liabilities, or are considering doing so, when setting the investment strategy. The lack of interest in hedging inflation and interest rates therefore reflects differences in Swiss pension legislation:

- the benefit, via the interest credit, being linked to a combination of future and historic returns on a defined group of asset classes rather than directly to inflation; and
- discount rates used for funding not being directly linked to bond yields to the same degree as the calculations for international accounting, or the costs of insuring benefits.

Naturally, the majority of respondents have not yet considered providing employees with investment choices to reflect their individual risk-return desires. As most companies have too few employees with sufficiently high levels of earnings to enable this to be done effectively, and with legislation still pending, it is perhaps surprising that as many as one in four respondents are either considering or have already implemented this 1e approach. Although this high figure is certainly not representative for the whole pension fund looks, we see a growing interest in 1e plans.
This would seem to suggest that there could be strong interest in passing the risk-return responsibility from the employer to the employee where legislation permits. This may reflect a desire to reduce risk, or a culture of employee empowerment. It may alternatively, be being used as a way of reducing the current cross-subsidies from actives to pensioners (as benefits will usually be paid as a lump sum) and between higher-earners and lower-earners. Given the number of employees with sufficiently high earnings is usually small and the administrative platform to run such plan being sophisticated, Collectives (multi-employer plans) will perhaps become the primary route to providing such plans.

**De-risking measures**

<table>
<thead>
<tr>
<th>Measure</th>
<th>Done (%)</th>
<th>Considering (%)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Move from DB to DC</td>
<td>75%</td>
<td>8%</td>
</tr>
<tr>
<td>Reinsure death and disability risk</td>
<td>40%</td>
<td>17%</td>
</tr>
<tr>
<td>Liability matching assets</td>
<td>35%</td>
<td>38%</td>
</tr>
<tr>
<td>Plan with employee investment choice (art. 1e BVV2/OPP2)</td>
<td>15%</td>
<td>10%</td>
</tr>
<tr>
<td>Move to variable pensions</td>
<td>10%</td>
<td>25%</td>
</tr>
<tr>
<td>Insure longevity risk</td>
<td>6%</td>
<td>10%</td>
</tr>
<tr>
<td>Fully insure retirees (buy-out with insurer)</td>
<td>6%</td>
<td>10%</td>
</tr>
<tr>
<td>Fully insure pension plan for actives and retirees</td>
<td>6%</td>
<td>8%</td>
</tr>
</tbody>
</table>
Longevity Risk Reduction

The low level of interest in longevity hedging is consistent with the responses relating to monitoring of buy-out pricing that we saw earlier. However, deeper analysis shows that those who have a desire to hedge longevity are not usually monitoring the buy-out market. Those respondents who are monitoring the buy-out market typically do not have a hedging policy in place, and are also unsure about the longevity swap market.

It could surprise pension specialists outside Switzerland that around 70% of pension funds never check the cost of a possible transfer of their pensioners to remove their longevity risk. However, as mentioned earlier this is likely to be due to the low volume of such transactions that have taken place. In most markets, longevity risk transfer options have tended to grow with demand.

The longevity swap market in the UK is perhaps the greatest example of demand driving supply. A large market exists today involving a number of global reinsurers and banks. The origins were one company asking an Aon consultant whether they could remove their longevity risks without passing all the liabilities to an insurer. Connections with banks and reinsurers created a solution, and time and ideas evolved those solutions to be available much more widely, including in Switzerland.

As the charts show, benefit design is the primary source of hedging longevity risks. A small number of funds remain committed to Defined Benefit provision, but the vast majority have already adopted Defined Contribution provision (note that Swiss defined Contribution plans are assessed to be defined benefits plans outside Switzerland). The longevity risk is therefore manageable by the Fund Board in the choice of the conversion terms at retirement and/or by capping the amount of the benefits being paid as a pension.

Changing conversion terms does not, of course, resolve the longevity risk relating to pensions already in payment – and the change creates a discontinuity between groups of retirees, breaking the expectations of new retirees. However, we have witnessed an increasing number of Fund Boards making this hard decision to prevent their longevity and generational cross-subsidisation risks becoming worse.

Many Boards have put in place plans for how to evolve conversion rates over a period of time to smooth the cross-subsidy, and better manage employee expectations, though the majority of survey respondents indicate that they are not considering implementing the so called variable pensions.
2014 saw a movement away from bonds towards assets with a higher return potential. There was also greater diversification of asset classes which will have enabled a move efficient risk-return balance. These moves are consistent with asset movements seen in many other countries as pension funds seek wider sources of returns when faced with very low bond yields.

Within the bond categories there was a clear move from government bonds towards corporate bond and multi-asset credit allocations.

Changes to investment strategy in the last 12 months
Expectations for 2015 were for a continuation in the same direction as 2014 towards more diversification, though at the expense of a reduction in regular equity holdings as well as a continued move from government bonds.

As indicated earlier, the survey responses were collected immediately before the currency change on 15 January 2015, and the further reduction of yields that change triggered.

Despite this continued diversification, we believe that the average portfolio of a Swiss Pension Fund remains narrower in asset range than optimal.

We estimate that optimising diversification could give the average Fund an additional return of 0.5% pa without any increase in risk. A significant additional return potential when guaranteed interest returns are so far behind statutory interest credits.

Swiss pension funds do not yet explore the full opportunity set of alternative asset classes. If they are professionally set-up, the diversification benefits of alternative assets typically compensate more than additional costs related with these investments. By considering OPP2/BVV2 limits for alternatives assets, an extension of investments above the limits could require a corresponding governance that can be outsourced for those pension funds with limited resources or know-how.

Alternative Assets is increasingly used to describe wide range of assets beyond the traditional norms of equities and bonds. This example Aon-managed UK portfolio gives an indication of some types of assets that are grouped under this simplistic “Alternative” title.

**Example of some types of alternative assets**
Implementing Improvements

Nearly two-thirds of respondents indicated that they were concerned about:

- the growing workload created by statutory prescriptions and regulatory requirements
- the time pension board members, the investment committee and the employer had to invest in managing the pension fund.

This is hardly surprising since Parliament has significantly intensified its regulatory efforts in recent years, and the rising demands in terms of pension fund governance.

Almost half of respondents also indicated that knowledge is a challenge for members of pension boards. Every step favouring professionalisation, training and compensation levels commensurate with the corresponding responsibilities and commitment should be supported.

Obstacles to governance and decision making

If the costs of governance and implementation are disproportionate to the value achieved for employees (and the sponsor) a Collective fund is a clear solution. An alternative approach has become very popular in a number of countries especially the US and UK is for trustees to delegate actions that need the most specialist expertise and speed of implementation, the so called delegated investment management. This approach maintains the responsibility of the Fund Board in setting and reviewing the strategy, in establishing the operational and governance investment process and checking of its compliance and accuracy, but leaves the time consuming & specialist actions to external partners.
One in five respondents have already decided to delegate all elements of investment policy implementation to a third party. Others have delegated some elements of the investment governance process, with around one half expecting to have delegated some elements of the process soon.

Unsurprisingly, this was one of the few questions in the survey that showed some difference by size of Fund. Delegation is certainly more common amongst smaller funds, though there were a surprising number of larger funds that are already delegating some, or in a few cases all, elements of the investment governance process.
Conclusion

There is a clear continuing trend towards greater understanding and better management of the risks relating to pension provision in Switzerland and elsewhere.

**Diversification**

The steady drift of pension fund assets towards alternative asset classes reflects the desire to improve risk-return efficiency. A more diversified portfolio enabling access to higher returning asset classes that also reduces overall portfolio risk and so dampens the impact of market downturns.

**De-risking**

The desire to de-risk is clear though more challenging in Switzerland than in many countries. The liabilities don’t have the natural hedges that exist in many other countries, and the longevity risk-removal market is not yet widely seen as meeting pension funds’ needs. We believe this will change, as these risks and insurers are the same as exist in very well-established longevity management markets such as the UK and US. There may, however, also need to be some realisation that discount rates that are suitable for smoothing the funding of pension funds are not appropriate when considering the long-term cost of retaining or removing the risk of annuity payments.

**Delegation**

The increased activity to better understand and manage risks has, however, increased workloads leaving less time to ensure that all actions can be carried out effectively. Delegation of some activities has increased, but may need to do so more if pension professionals are to ensure they have sufficient time to focus on matters of strategic importance. The continuing growth in smaller funds transferring into Collective funds is the clearest example of this recognition of the need to delegate some or all activities to another party.
Aon Client Promise
Our Commitment to You

Aon Client Promise
Our commitment to ensure you receive value and personal service

Client Promise IQ

Client Promise Academy
Our modular training approach drives consistent value

Expertise

Innovation

Excellence

Results

Partnership

Discover

Review

Develop

Deliver

Client IQ

Aon IQ

Aon Client Promise

Our commitment to ensure you receive value and personal service

Client Promise Methodology
The way we work together to empower results
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Aon Hewitt in Switzerland

In Switzerland, Aon operates as Aon Switzerland Ltd with four business units:

- Aon Hewitt provides actuarial advice, investment consulting, pensions administration software and delivery, pension fund coordination services, and insurance broking for Swiss pension funds and their sponsors. Aon Hewitt also supports employers with their broader compensation & benefits agendas.

- Aon Global Risk Consulting providing holistic risk management advice to businesses, including captive management services to help manage pension fund risks.

- Aon Risks Services providing insurance solutions for businesses who wish to transfer rather than retain risks, including broking death and disability benefits, and pension operations to Collective funds.

- Aon Benfield providing reinsurance advice and broking to insurers, including guidance to insurers looking to take on pension fund risks, or specific longevity risks.
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