

# Making up lost ground

How Switzerland's second-pillar pension funds can improve their investment performance

## Key messages

1. A dangerous mix of aging societies and low returns is putting pressure on pension systems in most OECD countries, leading many governments to implement extensive reforms. The typical recipe includes raising the retirement age, increasing contributions, and reducing benefits.
2. While Switzerland's pension system is more robust than most, this condition is unsustainable without urgently needed changes. And, while investment performance is a key driver of pension savings in the second pillar, current reform proposals largely ignore this lever.
3. Our new study reveals that Swiss second-pillar pension funds are significantly underperforming their leading counterparts abroad. We find a performance gap of 60 bps to 115 bps p.a.—or one-quarter to one-third of their achieved investment returns—between Swiss funds and peer institutions in the Netherlands and Canada. Swiss pension funds invest more conservatively and are less successful at outperforming their asset allocation benchmark.
4. Closing this returns gap would make other necessary adjustments to Switzerland's pension system much less painful. Had Swiss funds performed at the level of their Dutch or Canadian counterparts between 2008 and 2018 (adjusted for currency and other factors), they would have added CHF 50 billion to CHF 95 billion to the country's roughly CHF 900 billion in pension assets. Extrapolated to the full working life of an average Swiss employee, peer-level investment performance would translate into 10 percent to 25 percent higher annual pension payments.

5. Capturing these benefits requires decisive actions in three areas: 1) improving the way pension funds invest their money, 2) modernizing the regulatory environment in which they operate, and 3) consolidating the fragmented pension fund landscape.

## Key insights

### Switzerland's pension system is strong, but reform is increasingly urgent

Many pension systems in developed countries are at risk of failure. As societies age and interest rates stagnate, retirees are receiving ever smaller pensions relative to their last working salaries.

Switzerland still has one of the most robust pension systems in the world. In 2018, it ranked fifth in terms of total pension assets relative to GDP and first in pension assets per capita. However, our moment of reckoning is coming. The replacement rate (pension relative to last income) has dropped by more than 10 percentage points since 2008 and is projected to fall further, the current minimum conversion rate is also unsustainable. On two occasions, politicians have attempted reforms aimed at raising the retirement age, increasing contributions, and lowering benefits. However, their reform proposals were rejected and, as a result, Switzerland's second-pillar pension system has been steadily losing ground to the best systems globally, such as Canada and the Netherlands.

Today, reform of Switzerland's second pillar is once again under debate. However, there is reason to doubt that any of the proposals will be ambitious enough to sustainably address the system's inherent challenges. Particularly discouraging is the fact that none of them include levers for improving pension funds' investment performance.

## **Swiss pension funds' investment management practices disappoint, and so do their returns**

Comparing the investment performance of pension systems in different countries is not straightforward because system designs differ, foreign exchange effects can be significant, and national capital market characteristics affect pension funds' ability to earn attractive returns. To account for these differences and get an accurate performance comparison, we use a two-step process to assess how Swiss second-pillar pension funds perform compared to their peers in Canada and the Netherlands—two globally leading pension systems.

We find that over the 11-year period between the start of 2008 and the 2018 year-end, Swiss funds underperformed their Dutch peers by 60 bps and their Canadian peers by 115 bps p.a. While this performance gap partly reflects Swiss funds' more conservative asset allocation (especially compared to Canadian peer institutions), much of the difference is explained by our funds' lower ability to outperform a passive benchmark that replicates their asset allocations. These results are largely due to Swiss funds' smaller average size compared to their Dutch and Canadian counterparts—along with the lower economies of scale, less efficient choice of investment vehicles, and weaker governance and risk management practices that typically come with it.

Over more than a decade, an additional 60 bps to 115 bps in annual investment return can make a huge difference to a pension system's sustainability. Between 2008 and 2018, Swiss second-pillar pension funds could have added an additional CHF 95 billion to their total CHF 900 billion in pension assets, had their investments performed on par with their Canadian counterparts. Extrapolated to the full working life of an average Swiss employee, this investment performance would imply a jump of 24 percent in annual pension payments—or almost 4.5 years in delayed retirement that could be avoided.

### **Making up lost ground—a call for holistic reform**

Capturing these benefits is possible without taking undue risks or making big leaps of faith. It simply requires the willingness to learn from the world's best pension markets—and to take action in three areas:

#### **1. Swiss pension funds should strengthen their investment management practices**

Swiss second-pillar pension funds should shift their investments toward more cost-effective implementation styles while gradually adding more risk. They should avoid costly investment vehicles such as fund-of-fund structures and explore opportunities to manage more of their assets internally.

Over time, they will likely have no choice but to increase their exposure to riskier asset classes, but to oversee such investments effectively, they should strengthen their investment and risk management capabilities. Swiss funds are often staffed thinly and overly reliant on external managers and advisors, in contrast to their more sophisticated foreign peers. Investment governance is another area of weakness: too often, fund objectives are ill-defined, responsibilities are unclear, and trustees lack necessary expertise.

#### **2. Regulators should remove outdated constraints while fostering performance accountability**

Regulators should modernize investment rules governing Switzerland's second-pillar pension system. Existing regulation defines the list of permitted investment categories and specifies limits on how much can be invested in each. This is not in line with international best practices and risks creating adverse incentives for pension fund decision-makers.

Individual funds' performance should also be more transparent and easily comparable. This would increase decision-makers' accountability and improve overall outcomes, enabling pension fund sponsors and beneficiaries to ask the right questions.

Additionally, Swiss lawmakers and regulators should ensure that any legally imposed assumptions or parameters reflect the actuarial reality of the country's second-pillar pension system. While there is good reason to define a minimum conversion rate for the mandatory part of Switzerland's second-pillar pension system, it is irresponsible to keep it at unsustainably high levels.

#### **3. Pension funds and regulators should both work to accelerate consolidation in the pension fund landscape**

The top 15 pension funds in Canada and the Netherlands are on average four times larger than the average fund in Switzerland's top 15. Given the benefits of scale, it is not surprising that Dutch and Canadian funds boast better performance and lower costs. Maybe even more importantly, greater scale tends to support better governance and risk management practices, which will be necessary as Swiss funds try to raise their performance in an increasingly complex environment.