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Switzerland: The safe haven trap

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Lukas Riesen and Alfred Bühler analyse the consequences for pension funds arising from the flight to 'safe haven Switzerland' and present possible solutions for dealing with this risk

The slim returns on capital markets of recent years represent a major challenge for the financing of pension obligations. This is doubly true for Swiss pension funds, suffering also from the country's 'safe haven effect'.

Many investors reduce investment risk in times of crisis by substituting risk assets with secure ones. This occurs for institutional reasons, as in the case of insurance companies, or due to increasing risk aversion as is often observed in the case of private investors. Investors traditionally see Switzerland as a safe haven, and insecurity with regard to growth and the global increase in state indebtedness have led to strong demand for Swiss investments. Superficially, this seems unproblematic for investors or even positive. A detailed observation of the consequences of the flight to safe havens shows, however, that interest rate and currency risks have increased and that this has had negative consequences for Swiss pension funds. Where measures to hedge these risks have not been taken, the safe haven effect has led to a dramatic deterioration of the financial situation, in particular for more mature funds.

Historically low rates

The yield to maturity for 10-year Swiss government bonds was more than 3% per annum before the outbreak of the credit crisis in 2008 (see figure). Since then, the yield to maturity has sunk, remaining somewhat less than 1% per annum for several months and is even below the level in Japan. Foreign demand for secure Swiss government bonds has without doubt accelerated interest rate developments. In certain market phases, the enormous demand for Swiss government bonds has even led to negative yields for short term paper. Investors were prepared during this phase to lend Switzerland money for two or three years and to pay for this. This seems paradoxical but it is about the price that must be paid to enter the safe harbour in a storm, and one with minimal counterparty and inflation risk. In addition, one must also take into account that space in this safe harbour is very limited and therefore prices very high. Switzerland issued bonds to the value of CHF5bn (€4.2bn) in 2011. As the number of pensioners is growing, the Swiss second pillar alone is generating capital to cover pensions in payment of around CHF20bn annually. As pensioners bear no investment risk and pensions in payment are not reduced even in the case of deflation, the ideal liability hedging portfolio consists of long term government bonds or long term bonds with minimal counterparty risk. Owing to this hedging requirement of pension funds and life insurers, even the theoretically resulting domestic demand for long-term government bonds is considerably higher than the supply. This will remain the case in coming years as long as pension obligations are guaranteed nominally.

Pension funds in fact made high returns from bonds thanks to the reduction in interest rates, although these supposed returns were outpaced by the corresponding increase in pension obligations. On the basis of today's low interest rate environment, it will not be possible to continue achieving high returns on bonds. Even in the case of an interest rate rise, which would be positive for Swiss pension funds, average annual returns on Swiss government bonds of more than 2% are extremely unlikely in the coming ten years, as losses on bond investments will first have to be recovered. The necessary long-term return to finance obligations is for most pension funds in the region of 3-4% per annum, however. Regardless of whether interest rates remain stable or the desirable scenario of a moderate rate rise takes place, many funds will not be able to achieve the rate of return necessary to finance their liabilities without either a substantial equity market recovery, benefit cuts or cash injections.

High franc rate

The flight to Swiss franc-denominated assets also led to an increase in the rate of the Swiss currency. In the three years following the outbreak of the credit crisis in mid 2008, the franc increased by a third against the US dollar and by 40% against the euro. The upward pressure was so high in summer 2011 that the Swiss National Bank was de facto forced to intervene in the currency markets to support the export industry. The new established lower peg of 1.2 CHF/€ led to a devaluation of the franc. However, the value of the franc against the dollar and the euro is still considerably higher than before the crisis.

The portfolios of almost all Swiss pension funds are internationally diversified, which makes sense from the perspective of portfolio optimisiation. The resulting currency risks are not consistently hedged by all pension funds, however. As the Swiss franc is a safe haven in times of crisis, omitting to hedge currency risk in market crises leads to two-fold losses. Alongside low equity prices in local currencies additional losses arise due to the increase in value of the Swiss franc.

Weaker sponsors

Swiss exports account for more than 50% of GDP and are of critical importance for the health of the economy. The strong franc has reduced the competitiveness of export orientated companies and also that of local suppliers. Many companies have in fact held their export levels, but the corresponding lower margins have in some cases affected profits. Pension funds are indirectly affected as the ability of sponsors to contribute to improve the funding level in cases of underfunding is additionally limited. If employees must also be made redundant, the recovery potential of the pension fund is lower as there are fewer active participants. Without a disproportionate contribution from the employer, a mature pension fund can no longer recover if it is underfunded.

Measures now undertaken

Pension funds can largely eliminate the interest rate and currency risks that arise through the safe haven effect by means of a thorough asset-liability management process. Interest rate risks can be reduced proportionately by means of appropriately structured bond investments and adjustment of benefit promises (eg, lump sum payments, basic and bonus pensions). Currency risk is relatively high as liabilities are exclusively denominated in francs, but can be avoided simply through consistent hedging. Currency hedging is particularly important when crisis-driven strengthening of the franc additionally impacts the financial situation of the employer. Swiss pension funds may be legally independent but the employer remains the most important bearer of risk in mature plans.

Benefit promises must be adjusted to meet economic reality, even with perfect risk management. The earlier the benefits are reduced to a realistic level or funded with additional contributions, the less likely major adjustments will be in the future. A continuous adjustment of benefits and contributions will avoid the disproportionate burden of individual groups of members and will ensure that Swiss pension funds remain on a stable basis for the future. If there are surpluses in a few years due to high equity returns, these can simply be re-distributed to the beneficiaries. Pleasant surprises will be easier to explain than neglected adjustments to meet economic reality.

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