



**Short-term objectives or constraints for pension fund managers vs long term goals of policyholders – an asset manager's view**

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# Short-term constraints vs long term goals – some observations



- Eurostoxx 50 1987 - 2006: Life insurers bought at the top and sold at the lows

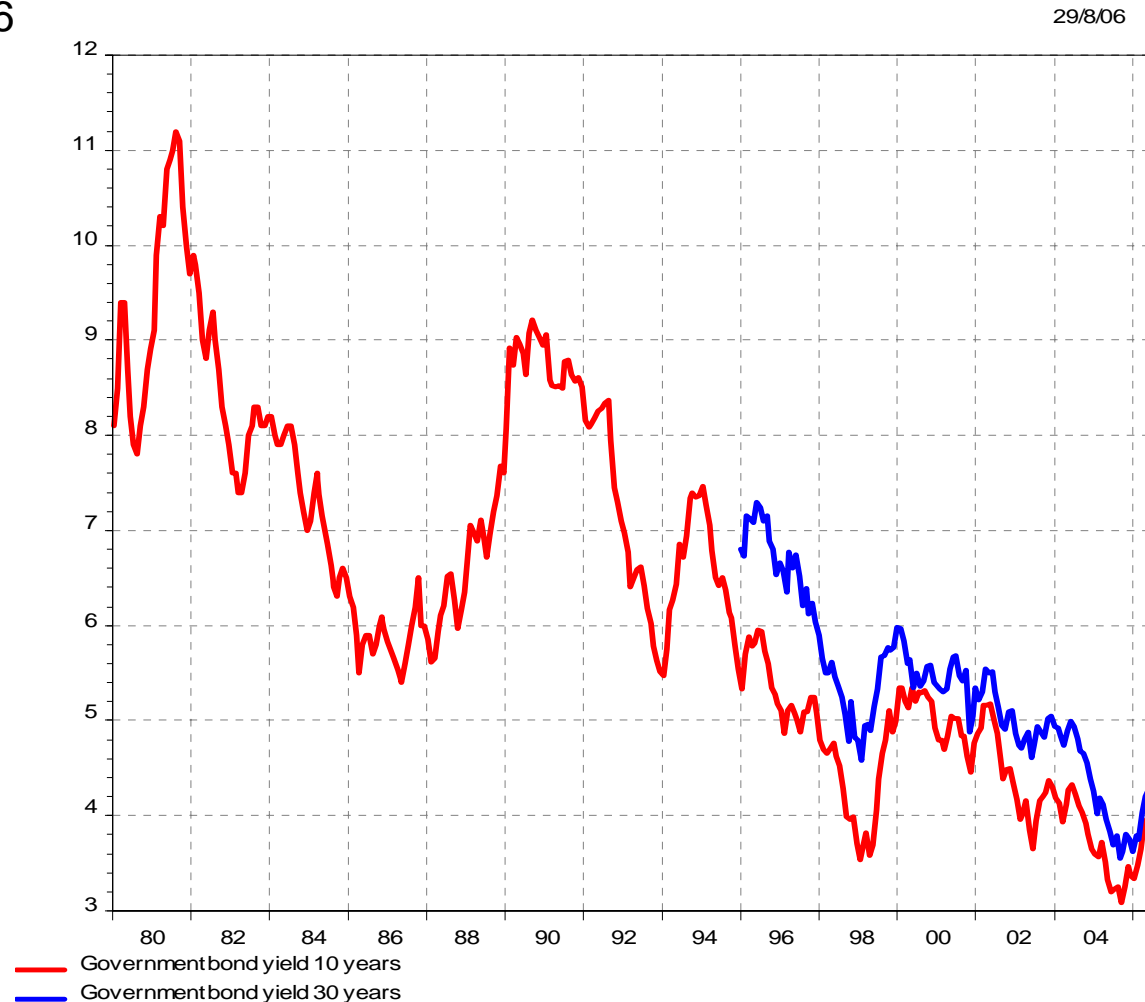


Source: Thomson Datastream

# Short-term constraints vs long term goals – some observations



- 10- and 30 year Euro interest rates. The bulk of European pension funds and life insurers extended duration to the max at the bottom of the global interest rate cycle in 2004/05/06



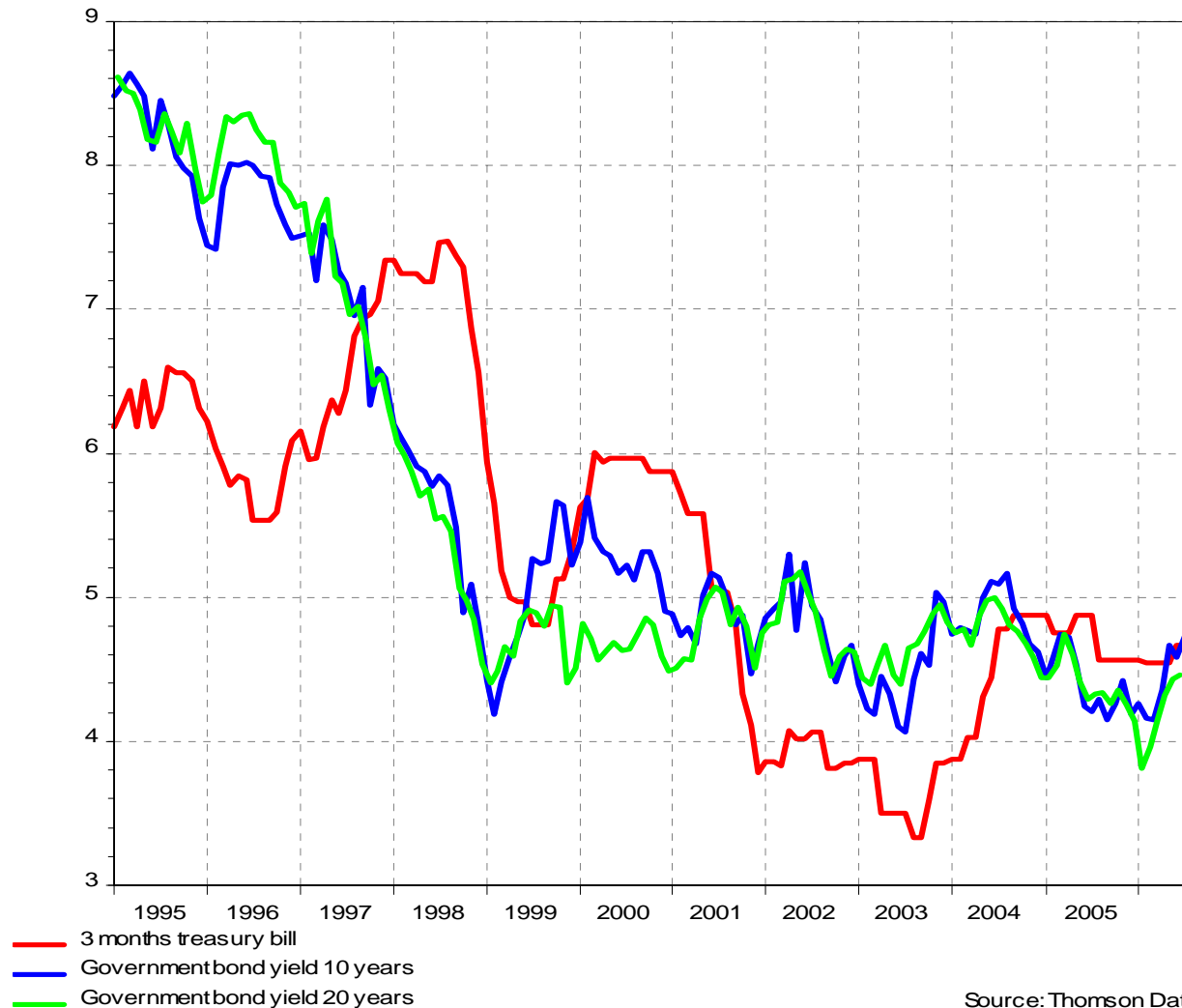
Source: Thomson Datastream

# Short-term constraints vs Long term goals – some observations



- British pension bought 30- and 50 year gilts, when the yield curve was steeply inverted, and real rates of those long-dated bonds were close to zero

29/8/06



Source: Thomson Datastream

## Preliminary explanations

- A case study about harmful interaction between failed regulation and inappropriate response / adjustment within the pension fund industry
- 1990s: A failed deregulation of life insurers by creating competition, leads to unsustainable guarantees and bonus promises
- ...which at the time apparently can only be fulfilled through higher risks / equity quotas
- Poor risk management leads to overinvestment and forced sales at the bottom of global stock markets
- Introduction of Solvency II / ALM-risk models (single period models) on a regulatory and corporate level enforces duration extension in a low-yield environment

# Regulations and systems have to deal with basic issues: Demography, structural change in the economy



Actuarial and risk frameworks are key

- What are technical interest rates on the liability side?
- How appropriate is the valuation of liabilities?
- What are prescriptions with respect to underfunding?
- How large, diversified and stable is the contribution base?

# Differences between pension funds and life insurers in Switzerland



- In Switzerland, big differences exist between autonomous pension funds and life insurers
- Life insurers, like their European counterparts or most European pension systems, are subject to tight funding restrictions, which in the end defend policyholder interests
- Life insurers may apply contract changes to deal with actuarial risks, while pension funds are more constrained
- Autonomous pension funds unlike other pension fund schemes in Europe are not yet subject to solvency II type ALM- or risk models or underfunding limits. Fair to say that this allowed for a fast and sharp recovery after 2002/03
- Autonomous pension fund regulation does not deal with long term key problems: Large scope for underfunding, inappropriate technical interest rates, underestimated liabilities, too many small pension schemes

# Sustainable high or optimized investment returns are a second key for the long-term efficiency of the system



- Pension fund schemes are savings institutions. Their long-term return is indicative for the efficiency of the savings process
- Given the dramatic demographic and structural challenges, to optimize the long-term return is the **key challenge today and in the future**
- But regulation does not primarily aim at optimizing those long term returns, instead it focuses on dealing with partial risks and issues of the past
- Furthermore, too many different regulations are set. Not just ALM or risk-models. Inappropriate legal quote schemes and accounting restrictions harm life insurers long-term expected return

# Single period risk models restrict expected returns



- Overall, single period risk models represent simple adaptations of investment bank / trading book models to long term savings institutions: Expected returns of risky asset classes should be different for time horizons between both types of institutions
- Single period risk models lead to suboptimal asset-allocations for pension fund managers.
- Overweight of bonds, long dated bonds above all, to cover long-term liabilities
- Too high risk charges for equities or other asset classes with higher long term returns, but with low short-term correlation to long-dated bonds

# Single period risk models restrict expected returns



- Life insurers can partially compensate by implementing equity type risk through corporate bond exposures and off-balance sheet products
- Trend of interest rates matters: Higher interest rates may create substantial risk capital
- Overall: Multi-period risk- or ALM-models as key to higher long term expected returns for pension schemes

# Legal quote participation schemes may result unintended effects



- Legal quote mechanisms intend to protect policyholder interests from a distribution point of view. Less focus on high long-term returns
- Legal quote mechanisms may differ from country to country, but they mainly rely on statutory accounting figures
- Bonds are typically dealt with only on an amortized cost base. Equities, currencies and derivatives may more directly impact total statutory returns
- The design of the legal quote system matters. Equity, currency and derivatives returns may have undesired distribution effects. Policyholders may fully participate to the upside, while the guarantee rate imposes the full downside onto life insurers
- For life insurers, other short-term constraints may scrap optimal long-term returns. P&L steering under US GAAP or IFRS. Equity volatility and accounting treatment may limit the equity quota



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