Fees: Clear on management costs

May 2017 (Magazine)

Ueli Mettler *and* ***Benita von Lindeiner*** *examine the difficult question of costs in Switzerland's second-pillar pension system*

At a glance

• There is a heated debate about asset management costs in Switzerland's second-pillar pension system.
• Disclosed asset management costs have increased since an official survey was conducted in 2011.
• Costs have risen for several reasons.
• A pension fund's board of trustees is obliged to act in the assured interest and to be aware of the costs and benefits of all investments undertaken by the fund.

Record low interest rates in developed countries and difficulties in financing pension schemes as life expectancy rises have led to an emotionally charged discussion about the future of the Swiss second pillar.

Potentially excessive asset management costs have been at the forefront of public interest since the drastic rejection of a proposal to reduce the minimum conversion rate in 2010. The effective level of these asset management costs has been the focal point of a much noticed cost survey in 2011, commissioned by the Swiss Federal Department of Social Security (BSV).

As interest rates have dropped even lower since 2011 and as the next attempt at reforming the Swiss second pillar is currently underway, cost sensitivity remains high and a closer look at the effect of this survey on asset management costs seems warranted.

The cost survey distinguished between three different kinds of asset management costs – the total expense ratio (TER), transaction and tax costs (TTC) and supplementary costs (SC). These costs were – contrary to custom at that time – gauged on all levels of the investment process, that is not only at the top level where they are explicitly invoiced, but also at lower levels within for example collective investment vehicles where they are usually netted with the achieved return.

Consequently, full costs measured for the Swiss second pillar – based on a sample of 73 pension funds with cumulated capital of CHF 230bn (€215bn) – were about 56bps or CHF3,900m – four times higher than the 13.3bps disclosed in the annual results and published in the official Pension Fund Statistics 2009. The resulting outcry was enormous as the public felt deceived by asset managers and regarded the result as a confirmation of the pension theft conjured up in the media prior to the referendum.

The Swiss government, however, did not give way to immediate cries for tighter regulation and a ban of certain expensive asset classes. Rather, in the context of an ongoing structural reform of the Swiss second pillar, transparency requirements were introduced in an amendment to the Swiss legislation covering occupational retirement that went into effect in 2013. The idea behind fostering transparency rather than providing directives and bans was the conviction that cost transparency would lead to cost efficiency – if investors were able to compare actual costs with effective returns, asset managers would be challenged and fees negotiated.

Six years after the cost survey, the new transparency regulation has been implemented four times already. Official pension fund statistics are available for the years 2013-15. Interestingly, disclosed asset management costs have continuously increased, reaching 48.8bps or 87.1% of the total costs estimated in the original cost survey.

The increase in disclosed costs can be attributed to the following factors:

• **Direct TER effect:** even before the introduction of transparency requirements, many collective investment vehicles had already included a TER price tag. This expenditure, however, did not form part of the income statements. When the new regulation became effective, this effect alone accounted for approximately 12bps or 20% of total costs according to calm estimations;

• **TTC effect:** while explicit transaction costs have formerly been netted with the transaction price, they now have to be posted as expenses. According to our estimations, this effect increased the disclosed asset management costs by another three bps;

• **Indirect TER effect:** the remaining increase in transparency is the result of an indirect TER effect. One of the most powerful instruments of the new transparency regulation is the directive that all collective investment vehicles lacking an officially acknowledged TER price tag need to be explicitly listed in the annex of the pension fund's annual results. To avoid perceived stigmatisation, the asset management industry undertook unexpectedly large efforts to obtain clearance on formerly opaque products. Investment foundations published guidelines for the calculation and publication of total expense ratios, the TER KGAST, in August 2012, and many large banks followed with compiled synthetic TER figures for their (alternative) fund of funds that added up asset management costs on all investment levels. Even private market vehicles were equipped with a TER concept – the TER SECA – in 2013 that was approved by the federal supervisory commission (OAK).

Interestingly, disclosed costs have not only shown a strong increase from 2012 to 2013 – but have also, albeit to a much lesser degree, risen significantly from 2013 to 2014. This increase was probably partly the result of a lack of experience and less particularity on the auditors' part – the first implementation of the new regulation was treated as a kind of grace period especially with respect to explicit transaction costs. At the same time, however, data show that the share of (expensive) alternative investments has risen from 6% in 2013 to 8.2% of total assets in 2015 – probably also accounting in part for the observed cost increase since 2013.

By now, only 7.2bps remain between disclosed costs and total cost measured in the cost survey. This difference can be attributed to implicit transaction costs such as spreads and to transaction and tax costs within collective investment vehicles.

The new cost regulation is considered to be highly successful both within Switzerland and abroad. Over 80% of formerly opaque costs are disclosed in the annual results today in a coherent, relatively simple and comprehensible way. All cost information is based on unambiguous and audited reports, ensuring full comparability with respect to level and quality.

Pension funds, active members and pensioners are sure to profit from the increase in cost transparency. Equipped with a clear notion of the price at which a specific return has been achieved, various optimisation processes have been initiated. The discussion about retrocessions in 2013 illustrates the effect that the disclosure of information has on all participants: measures to reveal and reclaim such payments were only undertaken after underlying mechanisms and cash flows were fully understood. This clearly proves that informational asymmetries are never at the interest of the investor; and the new transparency regulation has created the prerequisite to remove these asymmetries and to thus increase cost efficiency.

A pension fund's board of trustees is obliged to act in the assured interest and to be aware of the costs and benefits of all investments undertaken by the pension fund. It should consequently also strive to oversee cost components not covered by the new transparency regulations, especially with respect to implicit transaction costs of foreign exchange trading and transaction costs within collective investment vehicles.

We strongly advise all those responsible to carry out full costs analyses on a regular basis to fully understand the disclosed net returns.

However, an evaluation of these cost components will always to a certain degree require assumptions, which makes it difficult – and inadvisable – to create a common legal basis for their analysis.

Benita von Lindeiner is a senior consultant and Ueli Mettler a partner at c-alm, an independent consultancy based in St Gallen