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Occupational Pension
Supervisory Commission OPSC

Long-term investments in the low interest rate environment - Switzerland

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Pension Funds - Current situation

- Swiss Pension Funds invest EUR 1.5 – 2.0 bn in (foreign) infrastructure out of EUR 50 bn in alternative investments (including hedge funds, private equity and comodities), compared to EUR 150 bn in real estate and EUR 800 bn investments in total (including other LTI).
- Infrastructure investments are mostly indirect in collective investments (listed or unlisted).
- Infrastructure is growing within the growing share of alternative investments.
- Pension fund managers are looking for new investments, but are currently cautious about energy investments (low oil prices and uncertain political support for clean energy)
- Investment foundations (vehicles open for pension fund investments only) are offering infrastructure investments for smaller pension funds.

Limits and Potentials

- Limits:
  - Infrastructure is generally built by public sector entities («service public»).
  - Interest rates around 0%, i.e. low refinancing costs
  - Moderate public debt
  - No adequate charges to actual cost of infrastructure
- Potentials:
  - Public debt ceilings
  - Higher efficiency / lower risk
  - Political interest in «Swiss investments»
  - «Energy Strategy 2050» (EUR 200 bn)
  - Other: transportation, communication, social services
  - Local projects: hospitals, «Stade de Suisse»

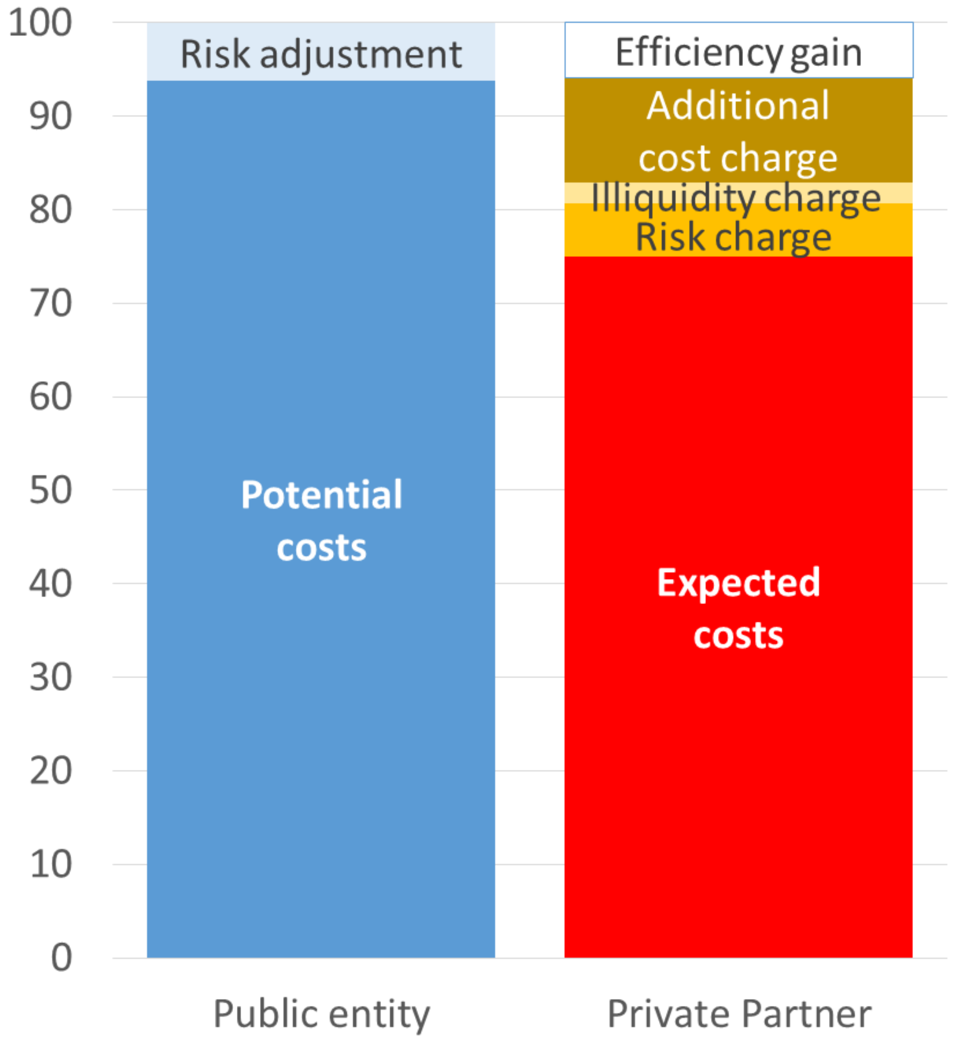
Goal: Win-Win-Situation

- For the government:
  - Infrastructure investing with a private partner is not more expensive
  - Risks can be reduced
- For the pension funds:
  - Stable cash flows
  - Fair risk premium (after costs) for regulatory and operational risks and illiquidity
  - Increased portfolio efficiency
- Does the low interest environment help with achieving these goals?

Case Study 1

- Infrastructure building, construction phase
- 5 year time horizon
- Fully financed by public entity vs. private partner
- Paid by public entity
- Assumed efficiency gains of 20% by private partner (using a private equity structure with a general partner and pension funds as limited partners)
- Risk transfer to private partner

Case Study 1: Efficiency gains

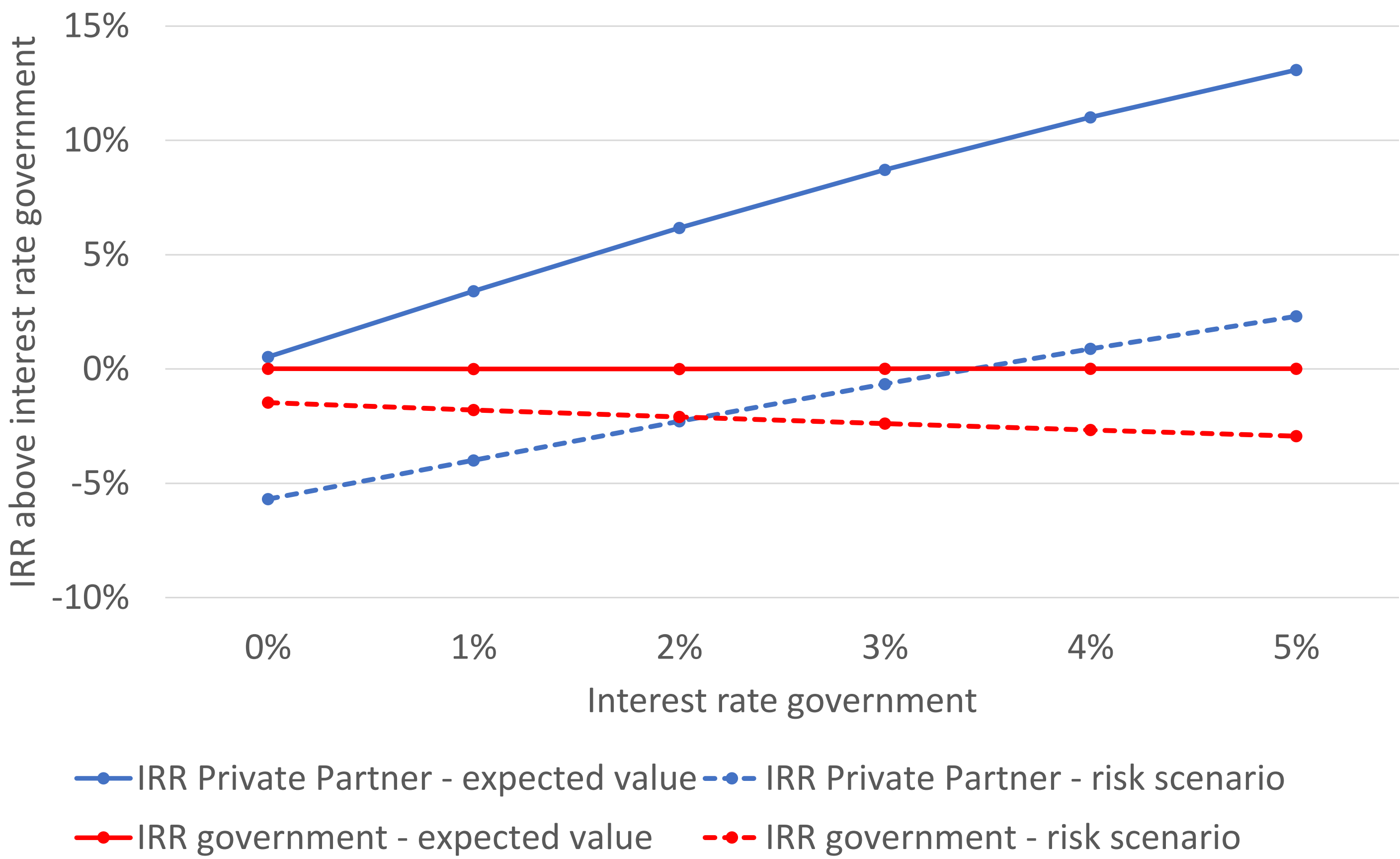


- Cooperation with private partner is not expected to be cheaper
- But: more predictable
- Project is win-win, if total charges are lower than potential costs plus risk adjustment
- «Skill» (of the general partner) is decisive

Case Study 2

- Energy facility, operational phase
- 15 year horizon, life time of the facility
- Assuming the government can borrow money at rate x%, a private investor pays x+2% for loan, and the price of the facility is calculated using an IRR of x% for the government. Inflation is assumed to be 50% of x.
- Turnover and operational expense expected to grow with inflation (same capacity, but price per kWh grows with inflation).
- A «worst case scenario» is calculated assuming that the output of the facility is 10% lower (over the 15 year period) and operational expense is 15% higher.
- Private Partner uses equity of 25% and a loan amounting to 75% of the price. Government uses (additional) debt.

Case Study 2: Interest sensitivity



- IRR starts to be interesting above 2% (general rule)

=> In a low interest environment, risk reward will be considerably lower.

Conclusions

- In a low interest environment, «skill» becomes more important. This means that pension funds may invest in pre-permissioning and construction phase projects («greenfield»). However, the government may work with the same partners as private investors, so this competition will lead to lower or no advantages for private investors.
- Long-term operational phase («brownfield») projects are less attractive in a low interest rate environment. Furthermore, interest rate risk will be higher than with (government) bonds.

The supervisor's view

- The objectives of pension supervision include
  - protecting the interests of pension fund members and beneficiaries,
  - safeguarding the stability of the pension industry and
  - contributing to the stability of the financial system as a whole.

  IOPS: Guidelines for the Supervisory Assessment of Pension Funds

The supervisor's view

- Infrastructure investments *are* alternative investments:

  [....] Alternative investments are characterised by [...]: the application of innovative financial products and derivatives, the use of extensive leverage, illiquidity of underlying investments, a greater reliance on the skill of the manager and the absence of a meaningful benchmark. [...] *IOPS: Good practices (GP) in risk management of alternative investments by pension*

- Thus, the supervisor expects that pension funds:
  - properly assess and manage the potential risks which these investments can pose *(GP1 / GP3 / GP6)*
  - make sure that the investments fit within the fund's risk profile and undesirable concentrations in the portfolio are avoided *(GP2)*
  - negotiate adequate contract terms and monitor them *(GP4)*
  - have transparent communication *(GP5)*

The supervisor's role

- Supervisors must make sure that pension funds have the skills to handle infrastructure investments.
- As fair contracts and diversification are key, they must make sure that the government does not force pension funds to invest in (domestic) infrastructure.
- They may use their role to address any issues with political risks with their government and use international contacts to raise this issue globally.
- Supervisors are important in building trust on all sides. Their independence is crucial.
- Less and better deals are preferable to many failures.

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