CFA Society Switzerland

Position Paper on Investment Governance at Swiss Pension Funds

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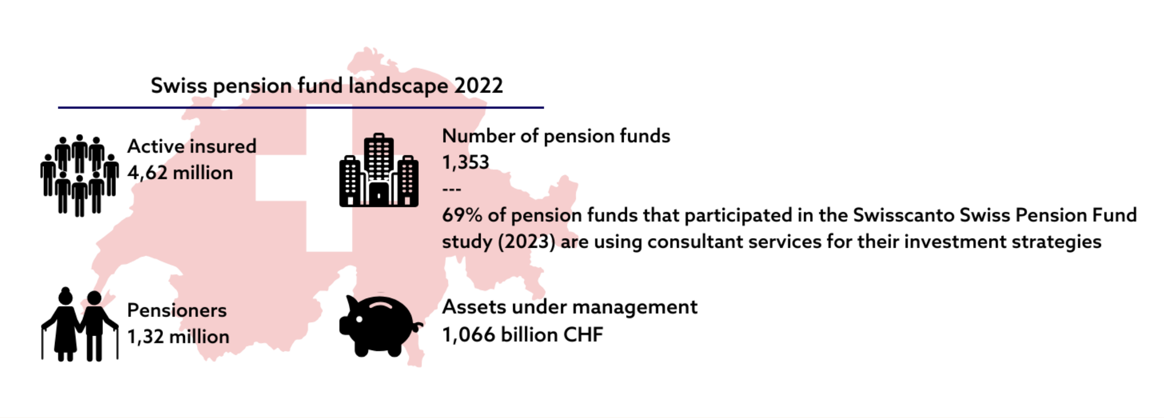
Introduction

The CFA Society Switzerland is the largest professional association of investment professionals in Switzerland. Our mission is to provide leadership to local investment professionals, by fostering the highest standards in ethics, education, and professional excellence in the investment industry for the ultimate benefit of society. Having started out with fewer than 100 members in 1996, we now represent more than 3,400 local members (CFA® charterholders) and form part of the global CFA Institute network, comprising 190,000 CFA charterholders in more than 160 countries. Together, we work to improve standards, provide high-quality education and training, support professional development, and strengthen our network of members.

A key goal of the CFA Society Switzerland is to shape the future of the investment industry. To that end, we advocate for professionalism, ethics, and integrity, as drivers of investor trust. As a non-profit organization that draws on the collective expertise of our members, we represent an independent and credible source for insights into the Swiss investment industry, its practices, and its outcomes.

One of the key sectors impacted by the investment industry is the pension system. The Swiss pension system is organized into three pillars, with the second pillar representing occupational pensions. The vast majority of pension funds in the second pillar are organized as foundations. Moreover, the system is highly fragmented, with institutions differing substantially in terms of size, liability structure, and available resources. This system, which is governed by the Federal Law on Pension Funds (BVG[1]) and its associated ordinances (BVV1 to BVV3[2]), assigns a central role to laypersons. The ultimate oversight and responsibility for a pension fund lies with the Board of Trustees (hereafter "BoT"), which is composed of volunteers who represent the employers and employees—the latter as so-called "beneficiaries." The challenge is that BoT members are not necessarily financial experts and dedicate only a fraction of their time to managing the fund. But managing and operating a pension fund requires a sound understanding of issues such as how to invest and monitor the fund's activities, as well as how to properly select third parties when delegating tasks, since there is a potential for conflicts of interest at all stages of decision-making and delegation. Moreover, as the pension fund environment is perpetually evolving, there is a need for further education and training both for BoT members and for pension fund employees.

Image 1 – The Swiss pension fund landscape[3]



1 SR 831.40.

2 SR 831.435.1; SR 831.441.1; SR 831.461.3.

3 Federal Statistical Office -Pension Fund Statistics 2022: final and key results; Swisscanto - Schweizer Pensionskassenstudie 2023

The objective of this document is to provide practical guidance on key aspects of investment governance that BoT members could—and potentially should—take into account when managing and guiding their pension fund.

The main benefits of effective investment governance include reduced risk of suboptimal strategic investment decision-making, reduced execution risk, and a more effective use of limited skills, resources, and time, all of which may ultimately lead to better investment results. That said, we do not claim that this document is the be-all and the end-all. Rather, it is intended to help members of the BoT and the pension fund management to address challenges they may be facing. In this spirit, we invite all readers to provide us with input, feedback, and suggestions at info@cfasocietyswitzerland.org.

On behalf of the CFA Society Switzerland, I would like to thank the authors of this paper for their dedication, as well as for sharing their valuable knowledge and expertise.

Mirjana Wojtal, PhD
CEO, CFA Society Switzerland

I. Investment governance – defining roles and responsibilities

INTRODUCTION

Pensions are a topic that affects everyone. In view of the current landscape, developments, and megatrends, such as the ageing of Swiss society, the pension system in its current form faces considerable challenges.

Investing is of paramount importance for pension funds. The first two sources of contributions are employers (the sponsor) and employees (the beneficiaries), while the third source of contributions is investment returns. The latter is in many cases the largest and most variable contributor to pension savings, hence its importance. Because the Swiss pension fund system relies heavily on volunteers, BoT members may, in some cases, not be investment professionals. For this reason, it is crucial for every Swiss pension fund to establish sound investment governance, thus optimizing the limited time, resources, and skills at their disposal. The term "investment governance" refers to the governing activities of the process or group of processes through which investment oversight and control are exercised and investment decisions made.

The investment process starts with how the BoT organizes itself to design, lead, manage, and oversee the pension fund's investments. This involves addressing investment beliefs and goals, managing risk, designing and implementing a strategy, agreeing benchmarks and comparators, structuring the investment portfolio, selecting third-party service providers, and monitoring and controlling the results. All of these steps in the investment process are fundamentally interlinked.

When implemented properly, investment governance makes a substantial contribution to achieving the results necessary to meet the pension promise. However, the effectiveness of investment governance in meeting these goals depends on the amount of time, as well as the resources and skills, available to the BoT. More highly developed investment governance will display a greater capacity to achieve higher returns for less risk, while more basic governance will have less capacity and will correspondingly seek to achieve lower returns for less risk. While there are many intermediary forms between highly developed and basic investment governance, the objective at all levels is to achieve the returns that the pension fund requires in light of its risk profile and pension promise. Hence, it is important for the BoT to align its pension promise with its ability to successfully navigate the investment process, as a mismatch will result in unwanted risk.

The various roles, responsibilities, and interactions between the BoT and both internal and external functions, such as individuals managing the pension fund's assets, are described in the following sections. The emphasis in this document is on investment governance. As such, it does not address all of the governance structures needed to run the pension fund as a whole or the management of its liabilities. That said, there is considerable overlap with these areas, given that the investment portfolio's sole purpose is to enable the pension promise to be fulfilled.

WHY A STRONG INVESTMENT GOVERNANCE FRAMEWORK IS NECESSARY

Members of the BoT are fiduciaries of other people's life savings. In this role, each member of the BoT bears a heightened level of responsibility and liability. Consequently, it is incumbent on the BoT to exhibit diligence, prudence, care, and skill when making decisions, as well as to ensure quality implementation. The level of investment governance is determined by the resources, skills, and time the BoT has for investment matters, including, in some cases, the volume of assets that the pension fund has available for investment. Accordingly, investment governance can be conceptualized as a quantity that is dependent on resources, skill, and time. This quantity is not fixed: it can be expanded if the BoT is willing and has the means to do so. A pension fund with a lower level of investment governance ought to make use of simpler investment strategies, while a pension fund with a high level of investment governance is able to employ more advanced and demanding investment designs and strategies. The BoT must be aware of the degree of investment governance that it possesses, if it is to employ suitable investment strategies. Well-executed investment governance at any level meets regulatory requirements. It ensures that pension assets are managed within the limits of the BoT's level of investment governance, in the best and balanced interest of its beneficiaries, the employer, and other stakeholders, such as authorities and the interested public. A BoT that not only understands the limitations of its skill, resources, and time, but also knows how to coordinate its duties and deploy its abilities effectively will be better placed to successfully steer its investment portfolio. Such a BoT will tend to avoid inefficient decisions that cause a drag on investment results, focusing instead on what is relevant for achieving the outcomes the pension fund needs. One relevant consideration is that appropriate investment governance will contribute to reducing execution risk, which is in the individual interest of all members of the BoT.

The five key elements of the investment process are as follows: (1) **"Governance"** refers to the BoT's decision about how to handle the investment process based on its understanding of the objectives of the pension fund, its investment beliefs, and how the investments relate to the plan's liabilities. (2) **"Risk"** refers to both the risks that are faced and how they are dealt with, since understanding the fund's risks is an important input for devising the investment strategy. (3) **"Strategy"** refers to the process of determining the fund's asset allocation, while respecting the risk the BoT is willing to take in order to best meet the needs of the beneficiaries. ALM is an ideal tool for incorporating risk when devising the most suitable investment strategy for the fund. (4) **"Implementation"** refers to three steps in the execution of the investment strategy: The first step is deciding appropriate benchmarks for the strategy as a whole and for each mandate per asset class. The second step is deciding how to structure the investment portfolio and its mandates—e.g., whether to hold the fund's investment mandates in a single investor collective investment fund or directly in its custody account or, in the case of a given mandate, whether to put it into the single investor fund or to hold it directly in the custody account or as a share of a third-party collective investment vehicle. Once mandates, including benchmarks and preferred structure, are known, the final step is to select the investment manager for a mandate. The investment manager may be an internal or external third party. Implementation may also involve selecting a single investor fund provider, a custodian, or a consultant or other third-party service providers. (5) **"Monitoring"** refers to, among other things, designing reports to reflect what the BoT needs to know to fulfill its task of governing the investment process. This also includes evaluating results and deciding any steps the BoT may want to take. The five elements of the investment process described here are generic, meaning that some pension funds may want to implement intricate approaches for each step, while others will prefer to keep things simple.

THE ROLE AND RESPONSIBILITIES OF THIRD PARTIES

Third parties provide pension funds with access to expert knowledge, financial markets, technology, and systems, such as:

- Asset servicing (custody, fund administration)
- Asset management (investments)
- Consulting (asset liability management, strategy advice, manager selection, legal and tax advice)
- Monitoring (investment controller, auditor)

The responsibilities of third parties are defined by contractual agreements and are limited to the specific tasks or services to be provided. Clearly defined and measurable deliverables allow for effective management of third parties by the BoT and the pension fund's management (see Box 1).

The BoT should ensure that the roles and responsibilities of third parties are written down in precise, clear, and unambiguous language. It should also put in place a structured process for selecting, regularly reviewing, and, if required, terminating relationships with third-party service providers.

The BoT is not captive to its level of investment governance. Capable third-party services may represent a valuable resource for enhancing investment governance or the BoT's ability to responsibly manage investments for the pension fund.

Box 1. Examples of measurable deliverables for a passive equity manager:

- Unambiguous definition of the investment universe
- Benchmark to track
- Expected tracking error range
- Disclosure of applied sampling methodology
- Use of derivatives
- Position limits (as needed)
- Reporting content and periods
- Total expense ratio (TER)
- Requirement to seek further instructions in the event of unforeseen incidents

RECOMMENDATIONS

The following sections outline important considerations that the board must take into account, both with regard to investment governance and when addressing its duties and delegating responsibilities to internal and external professionals. Our intention is to provide a template for the BoT to address important aspects of investment governance, in order to help it avoid overlooking anything of significance. While we do not claim that this discussion is exhaustive or that every recommendation is relevant for every pension fund, it will provide a basis for discussing these issues within the BoT.

1. The role of the BoT in investment activity

a. The BoT will define the investment beliefs and investment horizon it considers necessary to enable the investment outcome(s) needed for the pension fund to fulfill its obligations.

b. The BoT will define and document the pension fund's risk tolerance. The BoT may not delegate its ultimate responsibility for defining the pension fund's level of risk nor its understanding of risk tolerance.

c. Based on its investment beliefs, risk profile, and return target, the BoT will define its investment strategy. While the BoT may not delegate responsibility for monitoring the investment strategy, it may delegate individual tasks either internally or to third parties.

d. In defining the investment strategy, the BoT will apply asset liability modeling and consider return and risk expectations.

e. The greater the demands for investments to be carried out, the greater the investment governance requirements in terms of resources, skills, and time. If it is impossible to attain the required skill level due to a lack of sufficient resources or time, the BoT will consider delegating investment decisions to the internal investment office or to a qualified third party, with sufficient resources, skill, and time to fulfill its mandate.

f. The BoT will document its standards of practice and its responsibilities and duties, as well as those of its delegates. It will make the document available at a minimum to the beneficiaries and the employer, as well as, when necessary, to its delegates, who are contractually obligated to consider these standards of practice when providing their services to the pension fund. This document also contains a formal description of the fund's investment beliefs, strategy, and organization, including an organizational chart.

g. When delegating investment responsibilities, the BoT will select, instruct, and monitor the appointed party in an appropriate way, as well as documenting the decision and its execution. Any change of instructions must be provided by the BoT or its delegate(s). Appendix I. Checklist for best practices when dealing with third-party providers includes a sample template for delegating investment responsibilities, competencies, and decision-making powers.

h. The BoT may consider setting up an investment committee if the complexity of the pension fund's investments requires more attention. The investment committee may include members of the BoT with more investment skills and experience than others. It may consider appointing independent members to the committee who are professional investors.

i. The BoT will regularly monitor investment results, covering both risk and return, including the performance of all of its third-party providers, the investment office, and the investment committee.

j. The BoT will decide how to benchmark investment results and which benchmarks or comparators to use. It will ensure that the benchmarks broken down by asset category reflect, in aggregate, the aims of the investment strategy as a whole. The BoT may consider delegating the benchmark decision to the investment office or to an independent third party.

k. Investment monitoring processes will ensure that the information gathered from investment reporting is considered when reviewing and amending investment strategy/asset allocation and its implementation. The BoT will design the content of the monitoring report (including focus topics, investment controlling tasks, and performance) and the review process, as well as fixing the reporting frequency (quarterly reporting is recommended). In any case, the author of the report will be independent of any investment manager or any source of investment results.

l. The time horizon for concluding investment success for a pension fund does not correspond to the one-year regulatory reporting period. The BoT may consider different measures, such as the duration of the BoT's tenure, the regulatory period for recapitalizing any underfunding, or other reasonable time periods. The time period should be at least three years, but this does not preclude monitoring investment outcomes more regularly.

m. The BoT is ultimately responsible for steps a, b, c, f, g, and i.

2. Education and training

The BoT is responsible for the initial and continuing education of its members.[4] We suggest that this include investment office employees and members of the investment committee, if the latter are not already BoT members.

The BoT should focus its training and education needs on identified knowledge gaps and priorities, as well as the budget. Education should be tailored to the specific needs and competencies of each individual.

Tools used to address knowledge gaps include board evaluations, a skill matrix, and an implementation plan to ensure that knowledge gaps are filled.[5]

Topics for continuing education may include investment-related tasks: e.g., addressing investment-related matters in financial statements, monitoring investments, communicating investment activities and their results, and identifying and managing conflicts of interest. Continuing education related to more direct investment tasks may include, e.g., interpreting asset liability studies, risk management, investment strategy, improving members' understanding of asset classes to be considered for investment, aspects of hiring and terminating third-party providers (see "Third parties," p. 12), and overlay strategies, such as currency hedging or the use of derivatives, ESG approaches, and other tax-related and legal issues (see Box 2).

4 (Art. 51a, BVG)

5 Example of a skill matrix for a board evaluation: https://www.thepensionsregulator.gov.uk/en/trustees/governing-the-scheme/skills-and-experience

Box 2. Continuing education resources

With over 70 years of experience as a trusted provider of professional education, the CFA Institute offers both certificate programs and standalone courses covering topics that are specifically relevant to the investment industry, ranging from more traditional topics, such as investment industry fundamentals, performance measurement, risk attribution, and soft skills, to emerging concepts, such as ESG investing and data science.

CFA Institute certificates and courses

Recommendation: Investment Foundations® Certificate
Provides learners with an overview of the essentials of finance, ethics, and investment roles, giving them a clear understanding of the global investment industry, including its terminology and foundational concepts.

Recommendation: Certificate in ESG Investing
This certificate is designed for investment practitioners who want to learn more about how to analyze and integrate material ESG factors into their day-to-day roles.

Recommendation: Investment Manager Selection
This short course will enable you to apply a rigorous framework to the process of investment manager selection for both traditional and alternative investments.

Recommendation: Risk Measurement, Risk Attribution, and Performance Appraisal
Learn about risk measurement and attribution, as well as how to analyze portfolio characteristics to monitor managers' implementation of their investment mandate, along with several performance appraisal measures for evaluating an active manager's skill.

CFA Institute Research and Policy Center (RPC) is transforming research insights into concrete actions that strengthen markets, promote ethical behavior, and improve investor outcomes for the ultimate benefit of society.

Further local and international educational resources by other providers are available.

3. Duties of the investment office and the investment committee

In order to enhance investment governance, the BoT may consider establishing an investment committee and an investment office.

The investment office executes investment activities under the oversight of the BoT. The duties of the investment office range from operational tasks—such as executing payment transactions, mechanically rebalancing the fund's portfolio, and collating reports—to advising the BoT, as its center of investment expertise, in all aspects of the investment process and investment implementation.

The investment committee is a technical body, which operates as a subcommittee of the BoT. Within the limits of its indefeasible responsibilities, the BoT may delegate certain major investment decisions to the investment committee, such as selecting third-party providers, or require the investment committee to prepare certain decisions to be made by the BoT (see Box 3).

Box 3. Non-exhaustive list of BoT and investment committee tasks

Preparation for BoT to decide	
Investment Committee	• Risk measures and limitations • Specific rules for use of derivatives • Broad investment strategy • Selection of asset servicer and single fund management company • Design of monitoring report
Decides	
Investment Committee	• Implementation of investment strategy and choice of instruments (investment universe on subcategory and security-type level)[6] • Process for selecting third parties • Investment manager selection • Specific monitoring measures
BoT	• Investment guidelines and investment organization • Risk tolerance • Principles for use of derivatives • Broad investment strategy • Selection of asset service provider and single fund management company • Design of monitoring report and corresponding process • Action to take as a result of monitoring report findings, or delegation of this action to the investment committee

The investment committee's responsibilities and tasks may overlap with those of the investment office, but the discretion enjoyed by the investment office is usually more limited, particularly when it comes to making investment decisions.

The role, resourcing, and staffing of the investment office and/or investment committee potentially depend on the complexity of the investment strategy and the extent to which tasks are delegated to external third parties. Hence, small organizations with an effective setup of external advisors and consultants, as well as holistic and rigorously executed governance, may implement and monitor a relatively complex investment strategy.

6 Investment committee: % of allocation to sovereigns, corporates, exposure to domestic and non-domestic CHF bond issuers; listed vs PPs; rating limits, custom benchmark, etc.

When considering whether to outsource or insource, the BoT will need to strike a balance between the level of cost and the degree of control, assuming that the skills needed to meet expectations are available internally at a comparable level. This is particularly true given that investing is at the core of every pension fund. One example of how to make such a comparison is to request offers from third-party investment managers and compare their offering with the one provided by the investment office. A reasonable range for intervals of evaluation could be 3–5 years.

The investment office and the investment committee will be subjected to a regular comparison with third-party investment managers offering the same or similar services. Monitoring [7] will be ongoing and evaluation will occur on a regular basis, depending on the needs of the pension fund and the costs associated with such an evaluation. Usually, the investment office carries out monitoring while implementing the investment strategy. An external third party should review the decisions of the investment office from time to time.

4. Relevant stakeholders

Beneficiaries

The beneficiaries of a pension fund are all those individuals who make contributions in order to receive a pension or capital in the future, as well as those who are currently receiving a pension. [8] They are the most important stakeholders for any pension fund. Beneficiaries do not legally own any of the assets of the pension fund, but they have a claim on a pension or capital payment upon retirement. However, beneficiaries do have participation rights with respect to the pension fund, such as casting a vote to elect the BoT.

Employer

Employers set up pension funds for their employees and are thus very important stakeholders. The benefits of the pension funds are material parts of the remuneration of their employees, as the beneficiaries of the fund. If the pension fund is underfunded, it may request that the employer contribute to the refunding or restructuring,[9] respectively, along with the beneficiaries. The employer also nominates representatives for the BoT.

Supervisory authority/regulator

It is crucial for every pension fund to maintain a good relationship with its supervisory authority/regulator or any other relevant authority. This includes the timely provision of pertinent information concerning material developments regarding the pension fund's investment activity and related delegations of activities. Every pension fund should endeavor to cooperate with the competent supervisory authorities/regulators to proactively address potential challenges, material developments, and observations.

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7 Monitoring is concerned with different aspects and levels of investment activity, including strategic monitoring, risk monitoring, mandate monitoring (with performance attribution), peer-group comparisons at the mandate and portfolio level, and so on.

8 Other events that are covered and would result in the payment of a pension or a lump sum include an incapacity to work or the passing away of the beneficiary. For simplicity's sake, we only mention retirement here.

9 See art. 65d para. 3 lit. a BVG.

5. Third parties

General recommendations

The following recommendations are intended to provide BoT members with a template for how to select, instruct, and monitor third parties. They will provide a foundation for analysis, without making any claim to exhaustivity or applicability in every respect to all pension funds.

- Third parties should be nominated by the BoT or a subcommittee (e.g., investment committee) or by the investment office based upon the results of a competitive search process.
- It is recommended that the BoT nominates, regularly reviews, or terminates the investment controller and the auditor.
- All third-party mandates will be governed by written contracts. Third parties will re-offer the mandate in a competitive process at regular intervals, at least every 3–5 years, in order to ensure cost effectiveness and to maintain services fit for purpose.

Investment managers

- Third-party investment managers manage a part of the investment portfolio as a mandate.
- Investment management services should be awarded to the party on the market considered to best meet the requirements, after careful evaluation of benefits and disadvantages, as well as value for money. While costs associated with a mandate may be a material criterion, other aspects, such as skills and capabilities, resources, execution risk, operational setup, and legal and tax issues, may be just as material for selecting a third-party investment manager. An investment manager's track record should be used as material to formulate questions about their abilities, rather than as a decision criterion.
- The mandate is designed to reflect the risk and return characteristics that the overall pension fund investment strategy requires.
- Each mandate should be subject to written investment guidelines and a contract. The contract will specify the following points in particular:

    - Objective of the investment mandate (incl. investment beliefs)
    - Investment guidelines (strategic asset allocation, tactical asset allocation), investment style (active, passive) and tilt (e.g., smart beta, momentum, value, sustainable investing)
    - Investment risk restrictions or budget
    - Regulatory and reporting requirements
    - Description of tasks delegated to the investment manager
    - Process for providing instructions and notifications, as well as for communicating
    - Remuneration and associated costs (potentially including a sample calculation, particularly when applying complex remuneration, such as a performance fee)

- Any mandate, whether managed in-house or by a third-party investment manager, will be monitored regularly, reviewed annually, and evaluated on a regular basis. A reasonable interval range to carry out such evaluations could be 3–5 years, unless material inadequacies have raised questions about the abilities of the mandate to deliver.
- We suggest that the pension fund maintain a pipeline of investment managers as a backup for a designated mandate, in the event that the incumbent is unable to meet the designated standards. The investment managers engaged by the pension fund, including those in the pipeline, will be continuously monitored.

Investment controllers

- In order to ensure independence, the BoT should ascertain that the controller does not accept any other mandate for providing investment consulting services to the pension fund.
- The investment controller will continuously monitor (at least):
    - The return and risk objectives of the investment portfolio and of each mandate
    - The execution of asset allocation
    - The adequacy of any benchmarks
    - Compliance of any investment activities with the pension fund's investment rules, as well as the investment guidelines and contractual arrangements of any given mandate
    - The custodian's performance and contractual compliance
- The investment controller will issue a report describing monitoring activities, findings, and recommendations for the BoT to consider acting upon.
- The reporting interval will agree with the monitoring and evaluation interval that the BoT has determined in its investment rules (quarterly reporting is recommended).

Consultants

- Consultants may be appointed by the BoT in order to fill in any resource, skill, or time gaps in relation to the BoT, investment committee, or investment office.
- Consultants' services range from governance design to strategy development, portfolio structuring, manager selection, and performance measurement. Consultants will differ in expertise, experience, and resources.
- The BoT will keep any consulting relationships at arm's length.
- Consultants will be monitored regularly, reviewed annually, and evaluated in 3–5 year intervals. The monitoring, review, and evaluation periods will be shorter depending on the duration of the contract, which may range from a few weeks to five years.

Custodian or securities services provider

- The custodian is a key provider for the pension fund, normally a licensed and prudentially supervised bank or financial service provider with the same level of client protection as a Swiss bank.
- A single global custodian is recommended to ensure efficiency.
- The custodian will demonstrate financial strength and experience in performing its core and value added services.
- If the custodian belongs to a financial services group and the client pension fund receives services from other entities in the same group, the BoT should consider requiring information barriers. If the sharing of information between entities is not a concern, then the providers within the same group should show how exchanging information improves service delivery and explain how any conflicts of interest are managed.
- The custodian's performance will be monitored regularly, reviewed annually, and evaluated at at least five-year intervals. Performance will be determined using a set of mutually agreed and measurable targets to be achieved by the custodian.

Fund management companies and fund administrators

- Fund management companies and fund administrators are effective counterparties for pension funds that enhance investment governance. Fund management companies are usually the legal owner of securities or real assets that are invested through fund structures. Legal documentation defines the rights of the fund investors in the investment fund. Both fund management companies and fund administrators maintain a register of fund investors and manage in- and outflows, in kind or in cash.

While this section sketched a potential setup for the separation of different functions within the investment process, which is a prerequisite for good governance, the next chapter will address potential conflicts of interest when delegating tasks and outline proposals for how to mitigate or—where possible—avoid them.

II. Managing conflicts of interest

INTRODUCTION

While conflicts of interest are common in human society, it is the duty of any pension fund, and hence of the BoT, to put in place stringent policies and processes for managing them. The BoT must take all appropriate steps to identify and either prevent or manage conflicts of interest in any situation which concerns itself, its representatives and employees, and its beneficiaries. Each individual plays several roles, and these can come into conflict with each other. Mitigating or avoiding the adverse effects of these conflicts is crucial for ensuring that the person acts in the best interests of the beneficiaries of the pension fund, rather than favoring conflicting interests.

In pension funds, the BoT and subcommittees with decision-making power are entrusted with the responsibility of managing the retirement savings of their beneficiaries. They must therefore act in their best interests at all times. However, these decision-makers potentially face a range of situations or circumstances that could create a conflict of interest for the person involved, namely when personal interests potentially interfere with a person's professional judgment or duties. These personal interests, which could be either financial or non-financial, can sway the person's behavior or actions for or against a certain decision or outcome. The perception of a potential conflict of interest is sufficient.

In the following, we distinguish between two types of conflict of interest that can affect pension funds: (i) internal conflicts of interest, which arise within the pension fund's board, investment committee, or staff; and (ii) external conflicts of interest, which arise when the pension fund delegates some of its functions or tasks to external parties, such as asset managers, consultants, custodians, and so on. We will explain how these conflicts of interest may compromise the quality, objectivity, and integrity of the pension fund's decision-making process and outcomes, as well as how they can harm its performance and reputation. Finally, we will propose a framework for managing conflicts of interest.

In pension fund management, internal conflicts of interest are defined as situations or conditions that may create bias affecting:

- the objectivity of a person involved in joint decision-making with a pension fund BoT
- the credibility or integrity of a BoT, which can raise questions about the quality or objectivity of decision-making processes

In the case of external conflicts of interest, by contrast, we encounter a principal-agent problem. Misaligned interests can:

- compromise the execution quality of the mandate in favor of shifting primarily financial benefits or interest from the principal to the agent
- result in investment recommendations based on incomplete information or options - e.g., a consultant or investment manager may propose a "cheap one-size-fits-all solution" to take advantage of scaling, while failing to take into account the specific features of a given pension fund (liability structure, ability, and risk tolerance of the BoT or BoD)
- lead to a less favorable execution of transactions, suboptimal structures, or investment vehicles, and a suboptimal tax setup

The next sections will discuss internal and external conflicts of interest, outlining a framework with mechanisms that:

(a) identify potential conflict of interest
(b) create an environment that better aligns the interests of the various parties involved in decision-making at different stages

INTERNAL CONFLICTS OF INTEREST

The term "internal conflict of interest" refers to biases that may occur within decision-making bodies and staff at the pension-fund level. It thus concerns individuals who are directly associated with the pension fund, whether as employees, trustees, mandate owners, or in some other capacity.

In addition to material or financial interests, where a decision-maker misuses his power, authority, or knowledge to create side-profit for himself at the expense of the pension fund and its beneficiaries, several qualitative (non-financial) biases also exist.

Potential sources of internal conflicts of interest include:

- Desire to maintain a certain image in the eyes of friends and family or in the political sphere
- Career advancement
- Recognition for professional achievement
- "Conflicts of commitment"—i.e., redirection of time or focus from the primary appointment to a secondary project
- Personal (e.g., religious or ideological) beliefs and national loyalties
- Affiliation with institutional, political, or academic associations, or other pension funds
- Intellectual, theoretical, or academic commitments
- Competition or rivalry
- Published opinions or advocacy positions
- Differing personal time horizons

If the adverse effects of internal conflicts of interest are to be mitigated, countermeasures must be taken, the most important of which are outlined below. Generally speaking, maximizing information sharing (transparency) is the primary instrument for reducing the negative impact of conflicts of interest or the abuse of power on the best interests of the beneficiaries of the pension fund. Exposing actions that harm the beneficiaries' interests makes it much more difficult to engage in such behavior. Hence, most of the proposed measures in the following section aim to increase transparency in various ways.

Catalogue of measures:

A strong regulatory framework and expert guidance

Each pension fund must formulate integrity and loyalty statements, as well as policies. At a minimum, the requirements of the Federal Law on Occupational Retirement, Survivors' and Disability Pension Plans [10] and the Ordinance on Occupational Old-Age, Survivors' and Invalidity Insurance [11] must be met. Most pension funds also adhere to the Charta of the Swiss Pension Fund Association (ASIP), which represents a binding code of conduct.

Confirmation of loyalty and integrity

On an annual basis, each key person exercising decision-making or monitoring functions must confirm that they have met all the requirements and principles of the fund's integrity and loyalty rules for the previous twelve-month period. Key persons include: BoT members, members of the investment teams, and other staff who can influence decision-making (e.g., by preparing investment recommendations).

Within this framework, the principles of loyalty and integrity must cover the following aspects and allow for evidence of obvious potential conflicts of interest.

Confirmation:

- Of having acted independently and in the best interest of the pension fund.
- Of having not received financial or non-financial benefits from third parties and having not conferred such financial benefits or non-financial benefits on third parties. Non-financial benefits are presents, meals, entertainment events, or services for personal benefit. The BoT will determine the annual number and maximum value of non-financial benefits considered acceptable in the course of doing business.
- Of having not misused material, non-public information for the purpose of one's own personal financial benefit (e.g., front-running, parallel running, after-running).

Disclosure of:

- Ownership, personal relationships with, or mandates and roles at other entities that may directly or indirectly conflict with one's role at the pension fund.
- Past, present, and pending legal transactions and business relationships with parties related to the pension fund.

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10 Occupational Pensions Ac; SR 831.40

11 OPP2; SR 831.441.1

Register of potential conflicts of interest

It is recommended that the disclosures of everyone involved be updated regularly and recorded in the register of interests. Ideally, affiliations with academic, political, and other organizations that might influence the person's interests should be declared as well. On an annual basis, the results of the loyalty and integrity survey are made visible to the decision-making bodies. This helps to shape a common understanding of topics that potentially could compromise the objectivity of particular members or groups. Based on this information, countermeasures may be applied (see Case Study 2).

Board composition

Ideally, the BoT should meet the criteria below. It is important to acknowledge that certain criteria may not be universally applicable to all pension funds, given differences in size, resources, setup, or plan benefits and rules.

- **Balanced committees:** The BoT ideally comprises individuals with diverse backgrounds. Roles on the BoT, including the presidency and secretary positions, should be rotated over time.
- **Term cycle:** BoT members should undergo regular reelection, typically within a cycle of 3–5 years. Ideally, there should be some membership turnover from term to term.
- **Representation:** The BoT may consider weighted representation to reflect the views of different groups, such as generations, genders, professions, and hierarchical levels.
- **Independent expertise:** It is critical to have independent BoT members, with or without voting rights, who are experts in specific fields, such as actuarial advice, asset management, and pension law. These members should be subject to review or potential replacement after each election cycle.
- **Preventing conflicts:** It is essential to exclude any individual with a known relationship to a mandated asset manager or consultant, unless credible information barriers can be set up to prevent double functions.
- **Intergenerational conflict of interest:** The BoT should actively work to minimize intergenerational conflicts of interest as far as reasonably practicable.

Creating awareness of potential conflicts of interest

The BoT should both encourage and require regular education and training about board members' duties and the knowledge they need, as this is a vital part of raising awareness about the presence and risks of conflicts of interest. Attendance at any educational or training event should be recorded on the annual training confirmation form.

Adequate remuneration

Compensation should reflect the effort required and be sufficient to align interests and maintain focus on the BoT member's mandate. Establishing a consistent framework for compensation, such as an attendance fee per board meeting, is essential for incentivizing desired behavior. By contrast, hourly rates may unintentionally incentivize the multiplication of hours, projects, or similar activities.

If the statutes of the entity or rules of the sponsor prohibit or cap compensation, the sponsor should allow employed BoT members to use their work time to fulfill the mandate with the required duty (see Appendix II, Case Study 5).

Measures at all levels (BoT, subcommittees, staff)

- Whistleblower setup: observations regarding violations of integrity and loyalty should be reported to a confidential and credible contact. The option for anonymous notifications must be made available (e.g., a whistleblowing box).
- Multi-eye or four-eyes principle: Across all levels, material decisions cannot be delegated to a single individual. Any signing authority on behalf of the pension fund should be collectively held by two people.
- Any person with a potential conflict of interest must recuse themselves from decisions—merely abstaining from voting is insufficient. The individual in question must leave the room before the discussion begins, and they should also be excluded from receiving any information or documentation about that agenda item before it is discussed by the board, so that they are unable to influence other BoT members before a vote.

Discussion culture

An open discussion culture is also central for addressing conflicts of interest. Good moderation—e.g., by fostering balanced participation and establishing clear rules for expressing opinions—facilitates the classification votes. This not only reduces existing conflicts of interest, but also prevents the emergence of a breeding ground for further conflicts or coalitions that compromise objectivity, and thus the quality of decision-making.

EXTERNAL CONFLICTS OF INTEREST

As we saw earlier, the principal-agent problem underlies potential conflicts of interest between two parties involved in a contractual relationship, namely the principal and the agent (see also Part I, section 3, on third parties).

- Principal: the principal is an individual or entity that delegates decision-making authority or tasks to another party (the agent) to act on their behalf. The principal aims to achieve certain objectives by means of the agent's actions.

- Agent: the agent is the individual or entity entrusted with carrying out the tasks or making decisions on behalf of the principal. The agent, who may possess specific expertise, resources, licenses, or skills that the principal lacks, is expected to act in the best interests of the principal.

The principal-agent problem arises when there is a divergence between the interests of the principal and those the agent, leading to potential conflicts of interest that can impact the achievement of the principal's objectives. The key issue is that the agent may not always act exclusively in the best interests of the principal, but may be guided by their own interests or incentives. This situation can lead to moral hazard, in the sense that the agent takes greater risks because the consequences are mainly borne by the principal. Moreover, this can have other adverse consequences, such as the selection of an unsuitable investment, because the principal may have difficulty assessing the agent's true abilities or intentions, due to the fact that the principal does not have the same level of information as the agent (information asymmetry).

In the case of pension funds, these problems arise at all stages involving external partners. Starting from a top-down perspective, there are typically different tasks that may be delegated to external parties (see also Part I, section 3, on third parties):

- Strategic advice
- Selection of external managers
- Investment management / implementation of investment strategy / execution
- Monitoring and controlling processes
- Custodian services

If these different roles are held by the same party, several factors could create a conflict of interest:

- A strategic advisor might be inclined to primarily propose strategies where they themselves can offer solutions.
- If the selection of external managers and reporting/controlling is concentrated in the hands of a single agent, there is a risk that the agent will have an incentive to refrain from fair and accurate reporting.

While, in theory, separating all these functions minimizes potential conflicts of interest, it may not be possible to implement such a solution efficiently due to the pension fund's asset size, the policy of its sponsor, or internal staff size. In this context, checks and balances must be implemented within the smaller set of external parties who take on several roles (e.g., contractual design, additional transparency requirements in reporting, information barriers between teams taking over conflicting functions), and potential conflicts of interest must be prominently disclosed. The framework below outlines a set of procedures and principles concerning how to deal with potential conflicts of interest. It also provides guidance where the optimal configuration of the BoT and of its decision-making procedures is not applicable or cannot be implemented efficiently.

FRAMEWORK FOR MANAGING CONFLICTS OF INTEREST WITH THIRD-PARTY PROVIDERS

- **Engagement with third parties and scope of duties**

  - Set clear objectives and define mechanisms to hold the third party accountable; define quality standards (best practices) and a transparency level that make it possible to evaluate performance and monitor decision-making over time.

  - Evaluate any relationship with a stakeholder of the pension fund by a party who applies for a business relationship/delegation by the fund. If the potential impact on decision-making seems material, then measures must be taken, e.g., affected stakeholders of the pension fund can recuse themselves from any decisions regarding the delegation.

  - The allocation of mandates or the acquisition of external services should be covered by an obligation to execute requests for proposals/competing offers for all business above a certain threshold.

- Multi-eye or four-eyes principle: Board decisions cannot be delegated to a single individual. Materially important topics should be discussed by the BoT and any decisions related to these should be taken by the BoT members together. Any power to sign on behalf of the pension fund should be collectively held by two people.

- **Separation of duties**

  To mitigate the principal-agent problem, the major advisory functions, such as strategy, implementation / manager selection / execution, and investment controlling, should be performed by separate entities. If no separation of these functions is possible or desirable due to a lack of resources or scale, any potential conflict of interest should be made transparent to all decision-makers. In addition, internal mechanisms must be established to form an independent assessment about how to deal with the potential conflict of interest that has been identified. The ideal setup is as follows:

  - Any external service provider should only be deployed for one element of the investment process that concerns investment strategy advice or activities, implementation, and controlling/oversight advice or activities. Any party that is involved should not be in a position where it controls or monitors its own strategy, its implementation, or its controlling/oversight activity or advice (see text below, Case Study 1; see Appendix II, Case Studies 3 and 6).

  - Boards should, in the first place, avoid the presence of individuals with strong conflicts of interest. For example, they should not admit representatives of asset managers onto the board or in any other role than the one delegated to it. If a BoT member holds asset management functions at an external firm or for the sponsor, the individual may not propose investment products linked to those functions. If such products are discussed as investment opportunities by the BoT, the corresponding BoT member must recuse themselves ahead of that agenda item and the discussion.

  - If the aforementioned services cannot be separated or separation is too costly, an alternative approach may be applied. Potential conflicts must be disclosed within the BoT and plausibility checks need to be performed regularly by an independent BoT member or a subcommittee of the BoT. The subcommittee could be led by an independent BoT member and additionally consist of employees who are not directly involved in any investment decisions, yet who understand the pension fund's investment activities. The pension manager or the chief accountant might be a candidate for such a role or it may be delegated to an external (independent) advisor (see Appendix II, Case Study 4).

- **Regular review**

  - All external partners should be subject to review on a regular basis.

CASE STUDIES

Case Study 1 – Investment consultancy or investment management

A pension scheme appointed the investment consultant "Best Advice"[12] to advise on fund manager selection. "Best Advice" proposed to the trustees that they consider its own manager-of-asset-managers service, in which "Best Advice" picks the best-of-breed managers in particular asset classes. These offerings can then be mixed and matched depending on the client's investment objective and asset allocation requirements. The fund management services are typically contracted in a bundled form with clients.

The trustees asked "Best Advice" whether the managers were engaged on a purely performance-related basis or whether other considerations were applied. The consultancy assured the trustees that only common selection criteria, such as performance, quality of investment processes, and client service, played a role in the selection.

Subsequently, when completing the register of interests, one of the selected asset managers disclosed that they had paid a fee to "Best Advice" in order to be included on their platform.

Solution:
- The remuneration of the asset manager selection service must be fully disclosed at the beginning of the process. If a "participation fee" or anything of the kind is employed, it must be the same for all competing asset managers. A small participation fee to avoid arbitrary or unserious participation seems acceptable.
- The trustees may want to withdraw from the contract with "Best Advice" for the manager-of-asset-manager service, because of the potential conflict of interest which incentivized "Best Advice" not to select the best manager according to common criteria, but only those willing to pay the platform fee. This selection bias could potentially be acceptable to a pension fund, but only if the pension fund has full transparency regarding the conditions for access to the platform to "Best Advice."

Case Study 2 – Public pension funds and the multiplication of roles

Mr. Twofold, who is a BoT member for a public pension fund, is also a local politician. In this role, he has relationships with many stakeholders, including local banks, such as ShinyDollars, with whom he does business for the local authorities he represents.

Twofold is a member of the pension fund's investment committee. He insists on being present at an upcoming performance review meeting with bank and asset manager ShinyDollars. ShinyDollars underperforms all the other asset managers employed by far. At the meeting, Twofold points out many positive arguments for prolonging the business relationship between the pension fund and the bank, such as excellent client service and a shared interest in the local economy.

Solution:
- The potential conflict of interest described here may not be captured in a "register of interests." Hence, other mechanisms should be used to avoid its negative impacts.
- Managing relationships with service providers should mainly be done by the CIO (or internal investment teams) as a person employed by the pension fund, whose main economic interest therefore lies in the fund, rather than by members of an investment committee or trustees, who tend to have more links of economic dependency outside of the pension fund itself.

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12 Any names, characters, businesses, places, events, or incidents are fictitious. Any resemblance to actual persons, living or dead, or actual events is purely coincidental.

III. Perspectives on the future of pension fund governance in Switzerland

The realm of investment governance in Swiss pension funds is characterized by its complexity and the significant responsibility it carries. At its core, effective governance goes beyond mere checks and balances and the management of conflicts of interest to embody a deeper ethical responsibility, which entails a commitment to act in the best interest of beneficiaries, with transparency and integrity.

One critical aspect of investment governance is the need for professional expertise and sufficient capacity to carry out the relevant oversight, even as BoT members usually carry out their function on a voluntary basis. It is also important for the BoT to consider the pension fund's structure and characteristics, which define its capacity for investment risk. In a constantly changing economic landscape, agile strategy formulation is essential. The BoT must also adapt to market shifts and regulatory changes, while maintaining a focus on long-term goals. This requires a nuanced understanding of global economic trends and the specific needs of beneficiaries, such as for more flexible receipt of pension benefits. This situation, coupled with the system's reliance on BoT, accentuates the importance of continuous education and the integration of diverse perspectives and independent expertise, which underpins robust decision-making and mitigates potential conflicts of interest, thus prioritizing the pension fund's integrity.

The role of third-party service providers is integral to modern investment governance in pension funds. Effective management of these relationships is crucial, in order to ensure that they align with the fund's objectives and values. The BoT must exercise due diligence in selecting, evaluating, and managing potential conflicts of interest.

Looking ahead, technology and innovation will play a pivotal role in shaping investment governance. The adoption of digital tools and analytics can enhance risk assessment and decision-making processes. However, the integration of this technology must be balanced against considerations concerning investment decision monitoring, data security, and privacy.

In conclusion, Swiss pension funds face a path marked by responsibility and opportunity. The BoT, which has the ultimate responsibility for managing the pension fund and acting as the steward of its beneficiaries, must navigate this path with wisdom, integrity, and a forward-thinking approach, thus ensuring the financial security of current and future beneficiaries and pensioners.

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Appendix

I. CHECKLIST FOR BEST PRACTICE WHEN DEALING WITH THIRD-PARTY PROVIDERS

1. The selection process for hiring third parties must be documented. It should contain information on the number of third parties considered, the selection criteria, the shortlist, and the proposed fees.
2. The contractual relationship between the fund and the third-party provider should be clearly defined.
3. Third parties should be regulated by a recognized authority.
4. Use checks and balances to avoid fraud and misconduct:
    a. Signature by two people for all contracts and agreements.
    b. Multi-eye or four-eyes principle for all control processes and payments.
    c. Benchmarking analysis on a regular basis (every 2–3 years, including foreign exchange transactions).
    d. Periodic retendering of mandates and other third-party contracts (every 3–5 years).
5. Strive for transparency by:
    a. Disclosing conflicts of interest.
    b. Documenting changes in agreements and guidelines.
    c. Documenting changes in key people and relationship management.
6. Rotate responsibility for relationships with third parties or define lead and deputy roles among staff.
7. Separate monitoring from consulting activities, as well as asset management from performance calculation, including benchmark calculation.
8. Establish an annual process for the signing of compliance letters by staff and external parties.

II. CASE STUDIES

Case Study 3 – Bundled or individual service contracting

The Happy Retirement pension fund employs LongLife as a scheme actuary. LongLife is responsible for the scheme actuarial valuation and advises on the fund's liability profile. LongLife also has an investment consultancy business offering services such as asset liability modeling and fund manager selection and monitoring. It also offers a range of investment services, including manager-of-investment-manager (or multi-manager) and liability-driven investment products. These latter services are commercial, rather than fiduciary. LongLife uses its position as scheme actuary to offer its other services to the Happy Retirement pension fund, either as a bundled service or individually.

Solution:

- As a matter of good practice, BoT should put the contract for additional services out to competitive tender and consider whether these services are contracted for separately or in a bundle. Trustees should consider whether investment consultants are best placed to offer these advisory services or whether there are other advisers who are better placed.

Case Study 4 – Investment consultants entering new activities creating biases

The investment consultant firm LuckyBet launches a new business line: on a web-based platform, recent retirees are offered the possibility to continue investing the capital taken out of the pension fund according to the same professional principles as pension funds. Asset managers can post their profiles on the web platform by paying a fee to the consulting firm LuckyBet.

Solution:

- This initiative links the economic interests of asset managers to those of the investment consultant firm, and biases LuckyBet towards recommending these specific asset managers to their clients.
- Going forward, LuckyBet should inform the pension funds that they advise on the selection of asset managers about their business relationship with these managers. They should also disclose relevant information, such as the fees paid by the asset managers, before engaging in consulting work.

Case Study 5 – Trustee remuneration

It is recommended that BoT members be remunerated for their contribution to the pension fund in accordance with the effort employed, while ideally not creating any incentive to increase it unduly.

- A pension fund remunerates its BoT members per hour worked for the pension fund. As the pension fund's highest authority, the BoT itself steers and controls remuneration. Remunerating time or effort provides an incentive to spend additional hours, e.g., on additional projects. While these may well be necessary or justified, this is not always necessarily the case. Fixed remuneration per service discourages this type of conflict of interest. A periodic review should be conducted to check whether it adequately compensates for the trustees' efforts.
- A pension fund BoT may include independent members who are not employed by the sponsor. Independent trustees must receive a fair and competitive remuneration for the hours spent working for the fund, in order to attract skilled individuals.

Case Study 6 – ALM/SAA studies

An asset manager carries out an ALM/SAA study for a pension fund. Believing that this allows him to enter into a commercial relationship with the pension fund, he recommends a significant allocation of investments and asset classes with high margins and in which his competitive positioning is good.

Solution:

- While some asset managers do provide competent services in SAA analysis, they should be told from the beginning that any selection of asset managers to implement the SAA will be subject to competitive tenders and that the decision will be based on objective criteria. The asset manager should receive a market-conform remuneration for their service as an ALM/SAA consultant.
- The full separation of all services provided solves the problem completely

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