

ECONOMIC SURVEY OF SWITZERLAND 2007:

ADJUSTING THE REGULATORY FRAMEWORK FOR THE OCCUPATIONAL PENSION FUND
SYSTEM

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from the section on pensions system in chapter 3*

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The financial situation of the occupational pension funds has improved

The financial situation of most second-pillar pension funds,¹ which had been jeopardised by the slump in financial markets at the beginning of the decade, has improved steadily in recent years. The combined impact of the stock-market downturn, the protracted decline in bond rates, and the earlier appreciation of the Swiss franc, which reduced the returns from investments in foreign currencies, resulted in large losses at that time. This significantly weakened the balance sheets of pension funds, as well as their investment income, which has traditionally been an important source of financing. Between 1997 and 2002, the average funding ratio (that is, the ratio of assets to the present value of future commitments) fell from more than 120% to around 95%, below the legal requirement. However, their financial position has improved sharply in recent years: in 2005, the average return across pension funds² was more than 11%, the accumulated return over the last six years reached 16% (an average of 2.5% per annum) and the average funding ratio had returned to 115% by mid-2006. The share of funds with a funding ratio of less than 100% fell to 3.4%. Likely reflecting the fact that public-sector funds benefit from a guarantee by the respective local government and thus are not legally required to be fully funded, it is estimated that almost half of them have average funding ratios below 100%. This funding problem is not likely to have significant consequences in terms of near-term solvency, since at the system's present state of maturity most institutions' revenues are higher than their current expenditures. It poses a more serious concern in the long term, however, as higher life expectancy (which, as discussed above, will in all likelihood continue to grow) will increase the expected outlays of annuity payments once contributors retire. As the value of the annual payment from the accumulated assets in the compulsory second-pillar system is set by a pre-determined conversion rate, the risk of higher-than-predicted life expectancy falls squarely on pension funds. Funds are registered in the canton where the major part of the business of the employer is conducted, and they are under the supervision of authorities set up by cantons (some cantons have set up

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1. Made compulsory in 1985, the second-pillar pension system is fully-funded, mandatory, and occupational based. Total assets under management in this employer-based system exceed 100% of GDP.
 2. As measured by the PICTET LPP Index 93, which is available at the following website: www.pictet.com/en/home/finance/indices/lpp93.html.

regional authorities). As a result, even though they are bound by federal regulation, the supervision of pension funds is fragmented and uneven among cantons (IMF, 2006).

And new measures have been taken

In order to offset the increasing costs as life expectancy increases, the minimum conversion rate of accumulated assets for people insured under the compulsory second-pillar scheme will be progressively reduced from 7.2 to 6.8% as part of the most recent revision of the Occupational Benefits Act (LPP) in 2005. However, it quickly became evident that a further reduction was necessary in order to allow pension funds to meet their commitments. In early 2006, the Federal Council proposed a decrease in the rate to 6.4%³ by 2011, but this was rejected by Parliament in a first reading; it is still possible that the measure will be adopted in a second reading. In response to the past financial difficulties, the minimum guaranteed interest rate on contributions, which had remained unchanged at 4.5% since 1985, was reduced to 3¼ per cent in 2003 and further to 2½ per cent in 2004. The minimum rate of return, which is revised periodically by the government taking into account average market returns, in particular government bond rates, remained at 2.5% in 2005-07, but will increase to 2¾ per cent in 2008. While reforms to the regulatory and supervisory framework of pension funds are in an advanced stage, changes to the administrative setting of the system's technical parameters are, if anything, at an early stage of discussion.

A better regulatory framework and more reliance on the market to set key parameters are desirable

While the recent measures taken will help to consolidate the financial situation of the pension funds, there is scope for more ambitious reform along two main lines. *First*, the current regulatory framework should be modified. A more centralised approach to prudential regulation and supervision should be adopted, in which a central, nation-wide body would be responsible for the design of the regulatory framework and the issuance of directives to ensure the standardisation of regulations and supervisory practices throughout the country, while the cantons would remain responsible for the actual supervision of the pension funds. A framework along these lines would not only result in a more uniform supervision, but would also avoid duplication of tasks and permit economies of scale to be exploited more fully. In this respect, the amendments proposed to the LPP in summer 2007 that reinforce the central supervisor's attributes go in the right direction. In a longer-term perspective, greater transparency and surveillance of pension-plan administration is still needed to boost public confidence in the system, especially in light of the recent scandals in the sector, which have hampered workers' confidence in fund administrators. The proposed reform to the LPP also includes additional transparency requirements for fund managers, a welcome development. *Second*, the administrative setting of the key parameters of the system should be made more flexible and rely more on market information. Currently, the authorities are responsible for setting, among other parameters, both the minimum interest rate (2.5% *per annum*) and the conversion rate of accumulated assets into yearly payments at the time of retirement, and modifications must go through a lengthy political debate. In the case of the minimum rate of return on accumulated assets, it could either be abolished, or, if this is not possible, it could be indexed in a formal way to a market interest rate. Regarding the conversion rate, it would be advisable to allow the Federal Council to modify it without parliamentary approval if allowing it to be freely determined is not politically feasible. An additional element to consider when assessing the cost of pension provision is the budgetary cost of the tax incentives that are offered to encourage contributions to private pension plans. As previously recommended, the authorities should reassess these tax incentives (OECD, 2006b), especially as they may be contributing to the oversized current-account surplus (see Chapter 2). In Switzerland, as is the case in many other countries, occupational schemes enjoy favourable tax treatment, as contributions and the

3. The Federal Council used the following assumptions to arrive at the 6.4% conversion rate: a technical interest rate of 3.35%, a yearly return of 3.85% and demographic trends reflecting the most recent population scenarios.

income generated by invested assets are tax exempt. The budgetary cost of these incentives, according to OECD estimates, are high, especially as participation in an occupational scheme is mandatory (Yoo and de Serres, 2004). The favourable tax treatment may encourage household retirement savings. However, this incentive applies only, to some extent, to the voluntary component of occupational pensions.

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