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Individual Choice in Social Protection: The Case of Swiss Pensions

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DIRECTORATE FOR EMPLOYMENT, LABOUR AND SOCIAL AFFAIRS

OECD SOCIAL, EMPLOYMENT AND MIGRATION WORKING PAPERS

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SUMMARY

1. In most OECD countries, the structure of the pension system does not give much potential for individual choice. The Swiss pension system is a particularly interesting case in this respect. Switzerland relies heavily on privately-managed, fully-funded pensions, which employers are obliged to provide. The employees have only a very limited range of individual choice within this system and there has been increasing political pressure to give members more control over their benefits. More choice would increase competition among funds, lead to higher returns on investment of pension funds, improve customer services and result in higher member satisfaction due to more tailored benefit packages.

2. This paper examines the choices currently available to members of occupational pension schemes in Switzerland and how they are making use of these options. It goes on to consider which expansions in choice might be desirable and what obstacles may be in the way of such changes. A particular concern is the lack of transparency in the current system, which, if it were to persist, could prevent people from making properly informed choices. The analysis draws extensively on the relevant experience of other countries — principally, Australia, the United Kingdom and the United States — all of which have expanded choice in their private pension systems.

3. The paper finds considerable scope for increasing member choice without dismantling the current system of occupational provision of pensions. There are three areas in which members' options might be expanded: portfolio choice, choice of pension fund manager, and choice of fund withdrawal:

- Member choice of portfolio could be offered in two ways. In the first, funds would be permitted to offer member choice. This would necessitate some legal and regulatory changes and effective supervision. In the second, funds would be required to offer different investment options. Subject to a series of safeguards, either of these policies could significantly improve members' welfare without compromising the existing system.
- Member choice of pension fund manager could have a more profound effect on the occupational pension sector. Nevertheless, choice of fund manager has been introduced in the United Kingdom without substantially undermining occupational pension schemes. Competition for managing members' pension assets could significantly increase levels of service compared with the current system: only poorly managed funds should have anything to fear. A series of safeguards would be needed to avoid problems of 'mis-selling'.
- Finally, member choice of withdrawal is again currently limited. The paper suggests that members should have access to at least some of their pension assets at retirement, which they could perhaps withdraw as a lump-sum or could invest in a draw-down scheme or a participating annuity. In either of these schemes, members that are more risk-tolerant could invest their funds more broadly and enjoy the additional return.

RESUME

4. Dans la plupart des pays de l'OCDE, la structure du système de pensions ne laisse pas une grande marge de manoeuvre aux individus. Le système de pensions suisse est particulièrement intéressant à cet égard. La Suisse s'appuie largement sur des pensions à gestion privée, entièrement capitalisées, que les employeurs sont tenus de mettre en place. Les salariés n'ont que des possibilités de choix très limitées dans ce système et les pressions politiques se font de plus en plus vives pour que l'on donne un plus large pouvoir de contrôle aux membres sur leurs prestations. Une plus grande liberté de choix augmenterait la concurrence entre les fonds de pension, conduirait à un meilleur rendement sur les investissements des fonds, améliorerait le service rendu au consommateur et se traduirait par une satisfaction accrue des membres du fait que l'offre de prestations serait mieux adaptée à la situation de chacun.

5. Ce document examine les choix actuellement accessibles aux membres des systèmes de pensions professionnels en Suisse et comment ceux-ci exploitent ces possibilités. On s'interroge ensuite sur ce qui serait souhaitable en termes d'élargissement des choix et sur les éléments qui peuvent faire obstacle à ce type d'évolution. Le manque de transparence du système actuel est un motif de préoccupation car, s'il perdurait, il pourrait empêcher les membres de faire des choix éclairés. L'analyse met largement à profit l'expérience d'autres pays – principalement l'Australie, le Royaume-Uni et les Etats-Unis – qui tous ont élargi les possibilités de choix en matière de systèmes de pensions privés.

6. Il apparaît qu'il serait amplement possible d'élargir les possibilités de choix pour les membres sans démanteler l'actuel système de pensions professionnelles. Il y a trois points sur lesquels il pourrait être donné plus de latitude aux membres -- choix du portefeuille ; choix du gérant du fonds ; et modalités de retrait :

- Le choix du portefeuille pourrait être institué de deux façons. Dans le premier cas, les fonds seraient autorisés à proposer un choix aux membres. Cela nécessiterait certains aménagements juridiques et réglementaires et une supervision efficace. Dans le second cas, les fonds seraient tenus d'offrir différentes options d'investissement. Sous réserve que soient prises diverses mesures de sauvegarde, ces deux formules pourraient notablement améliorer la situation des membres sans compromettre le système existant.
- Le choix du gérant du fonds de pension par l'adhérent pourrait avoir un plus lourd impact sur le secteur des pensions professionnelles. Néanmoins, le choix du gérant du fonds a été introduit au Royaume-Uni sans compromettre notablement les systèmes de pensions professionnels. Que les gérants se fassent concurrence pour gérer les avoirs de pension des membres pourrait notablement accroître le niveau des services par rapport à la situation actuelle : seuls les fonds mal gérés auraient quelque chose à craindre. Il faudrait prendre diverses mesures de sauvegarde pour éviter les problèmes de vente abusive.
- Enfin, la marge de manœuvre des membres en ce qui concerne les modalités de retrait est actuellement limitée. L'étude indique que les membres devraient pouvoir retirer au moins une partie de leurs avoirs au moment de la retraite, avoirs qu'ils pourraient peut-être retirer sous la forme d'un capital ou qu'ils pourraient utiliser sous la forme de rachats partiels ou convertir en rente. Dans l'un et l'autre cas, les membres qui ont une plus grande tolérance au risque pourraient investir leurs fonds de façon plus diversifiée et jouir du surcroît de rendement.

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INTRODUCTION

7. Individual choice potentially has an important role in social protection, because people differ in their circumstances and in their preferences. This paper is the second in a series that aims to assess the current and potential scope of choice in social protection; it does so by examining the case of the Swiss pension system The first, also on Switzerland, looked at individual choice in health care provision.

8. In most OECD countries, the structure of the pension system does not give much potential for individual choice. Publicly provided pension schemes usually have mandatory coverage and, in general, do not allow the insured workers to opt out of the scheme and take up other arrangements nor to modify the benefit package according to their own wishes. In most systems, the only flexibility offered relates to the age of retirement. Beyond the mandatory coverage, people are, of course, able to determine whether and how much additional voluntary provision they wish to make for their retirement.

9. The situation is different in countries which have pension systems with a substantial funded, privately managed component such as Switzerland, Australia, the Netherlands, the United Kingdom and, the United States. In such systems, workers can be given considerable choice in the composition of their benefit packages, in the investment of the funds accumulated, and in the management of the pension portfolio.

10. The Swiss pension system is a particularly interesting case in this respect. Switzerland relies heavily on privately-managed, fully-funded pensions, which are mandatorily provided by employers. The employees have only a very limited range of individual choice within this system and there has been increasing political pressure to give members more control over their benefits. Proponents of individual choice argue that more choice would increase competition among funds, lead to higher returns on investment of pension funds, improve customer services and result in higher member satisfaction due to more tailored benefit packages.

11. This paper examines the choices currently available to members of occupational pension schemes in Switzerland and how they are making use of these options. We go on to consider which expansions in choice might be desirable and the potential obstacles to such changes. A particular concern is the lack of transparency in the current system, which, if it were to persist, could prevent people from making properly informed choices. We draw extensively on the relevant experience of other countries – principally, Australia, the United Kingdom and the United States – all of which have expanded choice in their private pension systems.

12. The analysis is complicated by the absence of detailed information on the Swiss second pillar. The system is highly decentralised, and benefit and contribution structures, the use of insurance, investment policies and communication with members vary substantially between different funds. Detailed aggregate data on private pension funds, based on a survey undertaken by the Federal Office of Statistics, are published every other year with a two-year delay. Although the survey is wide-ranging, it does not report data on individual pension funds nor information on scheme finances, investment performance and operating efficiency.

13. The rest of the paper is structured as follows. We begin with a brief overview of occupational pension schemes in Switzerland. The subsequent sections look at different aspects of individual choice. Section 2 investigates how member choice of investment portfolio might be expanded. Section 3 looks at member choice of investment manager. Choice over the mode of withdrawal of pension benefits is assessed in section 4, while section 5 concludes.

1. Occupational pension schemes: a brief overview stressing choice-relevant features

14. The Swiss pension system consists of three tiers: (i) a public pay-as-you-go system that provides a basic benefit, (ii) an occupational, earnings-related and fully-funded pension system that is compulsory for all employees above a certain income threshold, and (iii) voluntary savings plans which enjoy substantial tax privileges. The system provides coverage for old age, disability and survivors' insurance. The first and the second pillar are "integrated", *i.e.* contributions and benefits and calculated to target an overall replacement of about 60- 70% of previous earnings.

15. The occupational pension plans are a mixture of defined-benefit and defined-contribution type. Most plans are technically defined-contribution schemes, where the pension value depends on contributions made, investment returns earned and the annuity rate applied at the time of retirement. But the Swiss government imposes a schedule of minimum contributions, a minimum rate of return and a factor for converting accumulated capital into an annuity, thereby targeting a defined level of benefit. Thus, the scheme in practice has a substantial defined-benefit component. The law also mandates immediate vesting and full portability of pension rights between different funds.

1.1 Institutional structure and governance

16. Employers have a range of options when setting up an occupational pension scheme while employees must participate in their employer's fund. Large companies usually establish their own single-employer fund. Many smaller companies join a pooled pension foundation to avoid the considerable administrative burden of establishing and running their own, independent fund. Pooled foundations can be autonomous or run by life insurance companies, banks, pension-consulting firms or employers' associations.

17. The law also distinguishes five types of pension institution by the risks they underwrite. So-called autonomous funds, generally operated by larger employers and multi-employer funds, insure benefits in-house or contract out only 'excess risks' to external insurance companies. The other three types of funds transfer the provision of benefits to insurers to varying degrees: semi-autonomous funds, for example, cover old-age benefits themselves but buy in coverage for disability and survivors' pensions.

18. Licensing and registration criteria are not particularly onerous by international standards. Pension funds must be legally separate from sponsoring employers and neither employers nor their creditors can have access to the fund's assets. Registered schemes (offering at least the mandatory minimum benefit) must have an equal number of employer and employee representatives on each executive committee. Employer representatives cannot include senior managers.[1]

1 Although this provision balances the influence of worker and employer representatives, it may inadvertently deprive boards of senior managers' professional expertise. Indeed, more experienced trustees in Anglo-Saxon pension funds might have contributed to more sophisticated management and better returns.

19. The board decides the statutes and governing regulations of the fund, and makes investment decisions. The pension fund must provide a copy of the plan's rules to their supervisory agency and issue an annual report. Although schemes must maintain appropriate accounts and provide expert certification of long-term financial health, there is no minimum capital requirement and no explicit minimum funding provision. However, private sector funds must be fully funded as determined by an actuary while public sector funds may be underfunded by up to 25% of liabilities. In the case of pension fund failure employees are compulsorily covered by a default fund.

20. In pooled foundations, individual occupational funds can keep their own contribution and benefit rules and investment committee under these pooling arrangements. While each affiliated fund is actuarially and administratively independent, assets are usually invested jointly. A joint foundation board, composed of representatives of affiliated funds and the managing firm, is responsible for cash flow and account management, benefit administration, and the investment of assets according to legal provisions. The foundation board can impose additional asset restrictions, although these must be approved by the affiliated funds. If an affiliated pension fund defaults, the pooled foundation is not liable, and the default fund steps in.

21. Pension scheme managers, auditors and pension experts are personally liable for any losses suffered by the pension fund due to of breach of trust or gross negligence. However, there are no detailed stipulations of robust internal control systems or the use of external custodians to prevent misappropriation of assets and ensure compliance with asset-allocation rules set both in the law and in the pension fund's own rules. The legal requirements for appointing auditors and pension experts, however, are much clearer than the lax provision for internal or external custody. Both types of professional advisors must be independent of the founders and managers of the pension fund. They must report to the competent supervisory authority any regulatory infractions and any problems that require immediate intervention. They must also notify the supervisory authority of the termination of their contract.

22. Pension experts must determine every three to five years that funds are able to meet their obligations and that the terms and conditions of the plan comply with legal provisions. Thus, their role is similar to that of appointed actuaries in Anglo-Saxon countries. There are no guidelines on actuarial assumptions, so the pension expert is free to choose assumptions of future wages, investment returns etc. Auditors and pension experts address some of the issues that would be the responsibility of custodians, but they are not involved in day-to-day operations. They might therefore be unable to prevent the misuse or misappropriation of funds, although they can ensures that malpractice does not go undetected for too long.

23. There are clear limits on pension funds' loans to and investments in their sponsoring employer, although these are lax by the standards of Anglo-American countries. Claims on sponsoring employers must be less than 10% of total pension fund assets if they are unsecured. Pension funds are required report to their supervisory authority any arrears in employer contributions that exceeds three months. However, in the absence of adequate internal control systems, breaches of these important rules might go undetected for long periods and could endanger the financial security of the pension fund. The risk of a breach is particularly significant in the case of small, uninsured pension funds.

24. The occupational pension sector is highly fragmented, with over 9 000 pension funds in 2000. However, the sector has consolidated over time: the number of providers was 17 500 in 1980. (Table 1). However, these raw data provide a misleading picture of the structure of the occupational pension sector because many funds have no active members.[2] Out of the 9 096 total of funds in 2000, only 3 418 (or 37%)

2 For example, many funds operate as charitable entities providing other welfare benefits rather than as traditional pension funds. A significant, albeit declining, number of funds are 'frozen'. They

had continuing contributors. All plans offering the mandatory benefits must register with the relevant agency. Some 2 599 (or 29%) of all schemes were registered.[3]

Table 1. Number of occupational pension funds, pension-fund members and labour force, 1970-2000

	Number of funds	Contributors (million)	Labour force (million)	Members/ labour force (%)
1970	15 581	1.3	3.1	41
1978	17 060	1.6	3.1	52
1980	17 500	1.7	3.2	53
1987	15 179	3.3	3.5	93
1990	–.	3.5	3.8	93
1992	13 689	3.4	3.8	90
1994	12 851	3.2	3.8	86
1995	12 200	3.2	3.8	84
1996	11 572	3.2	3.8	83
1997	–	3.1	3.8	82
2000	9 096	3.2	3.9	82

Source: Pension Fund Statistics, Federal Office of Statistics and Federal Office of Social Insurance

25. The mean number of members per fund is just 825, even excluding funds without active affiliates. However, this statistic belies the true degree of concentration in occupational pension provision. The largest 99 funds, each with more than 5 000 members, covered 2.2 million workers or 70% of the total (Table 2). This table again provides evidence of the consolidation of the sector. It shows declines both in the number of smaller funds and in the proportion of members that they cover.

Table 2. Pension funds by number of members, 1987 and 2000

Percent of total	1987		2000	
	Funds	Members	Funds	Members
1-99	74.8	4.9	50.8	1.7
100-499	18.3	10.7	33.2	8.2
500-999	3.0	5.8	5.9	4.3
1 000-4 999	2.8	6.8	7.1	15.9
5 000-9 999	0.4	8.0	2.8	69.9
10 000+	0.6	53.8		
Total (absolute numbers)	8 840	3.27m	3 418	3.23m

Source: Pension Fund Statistics, Federal Office of Statistics

1.2 Coverage

26. Coverage is compulsory for all employees whose annual income exceeds a floor equal to the maximum public pension. In 2003, the floor is SFr 25 320, equivalent to about 40% of average earnings. Since people on lower earnings will reach a replacement rate of at least 60% through the public pension (or

stopped accepting new contributions after the introduction of the new system in 1985 and continue solely for paying benefits.

3 Unregistered schemes with active members presumably provide top-up benefits for higher earners.

'first pillar'), participation in an occupational scheme is not deemed necessary. Enrolment is mandatory from age 17 for death and disability benefits and from age 24 for retirement benefits. There is a substantial difference in the coverage of the public scheme and of mandatory occupational plans. In addition to the minimum earnings and age thresholds, the self-employed, unemployed, disabled workers, and those working for less than three months cannot join a scheme unless the specific fund's regulations allow for their membership.

27. Workers have to join the pension institution established or selected by their employers and so have no choice of fund. When they move jobs, workers in most cases transfer their pension rights to the new employer's scheme. Some scheme's guidelines allow moving workers to leave their accumulated capital with the pension fund of their former employer, so they can belong to several funds, only one of which is active at any one time.

28. Coverage of occupational pension schemes was around 50% of employees before the introduction of mandatory participation in 1985 (Table 2). The raw data suggest that today over four fifths of the labour force are covered. However, these data include some double counting of workers belong to more than one pension fund. The correct number of members is probably around 2.8 million, or 74% of the labour force.

1.3 Contributions

29. Occupational schemes are generally financed by employer and employee contributions and investment returns on accumulated reserves. Compulsory contributions are levied only on so-called 'co-ordinated' earnings of members. This is the slice of pay between the maximum public pension and three times that level. The lower and upper limits are SFr 25 320 and SFr 75 960 respectively in 2003, equivalent to about 40 and 120% of average earnings. The difference between the floor and the ceiling – SFr 50 640 – is therefore the maximum income subject to compulsory contributions.[4]

30. However, pension funds often cover earnings outside the co-ordinated range. Only 16% of occupational scheme, covering 36% of total members, applied the legal limits on pensionable earnings in 1996. Some schemes set a higher upper limit while others imposed no ceiling at all. For example, around eight% of the total applied a limit of up to twice the legal level while 19% had an even higher ceiling. Most funds – 56% – had no ceiling (although these plans covered only 39% of total members). Occupational schemes can also dispense with the minimum earnings threshold, covering the whole of earnings rather than excluding the first slice, which would give lower-income workers better benefits.

31. As mentioned above, the government imposes a set of minimum conditions on occupational schemes specifying age-dependant minimum credits to individual accounts and a minimum rate of return.[5] Minimum pension credits are calculated as a proportion of co-ordinated earnings depending on age. The target is to achieve retirement capital of 500% of annual co-ordinated earnings for men at age 65 and 479% for women at age 62 (Table 3).

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4 There is also a minimum applicable income of one-eighth of the maximum public pension (SFr 3 165). Thus, contributions for all workers earning between SFr 25 320 and SFr 28 485 are set as if the worker had earned SFr 28 485.

5 Additional rules specify provision for disability and term life insurance.

Table 3. Credits to individual pension accounts by age (percent of 'co-ordinated' earnings)

Age		Annual credit	Accumulated credits	
Men	Women		Men	Women
25-34	25-31	7	70	49
35-44	32-41	10	170	149
45-54	42-51	15	320	299
55-64	52-61	18	500	479

Source: Federal Office of Social Insurance

32. Employers have to show that they can financially comply with this schedule even if they may be applying different contribution rates in practice. In 2000, employers paid 63% of contributions. There is a wide variation in the pattern and rates of contribution between different plans. In 2000, 24% of funds, covering 19% of total members, applied a fixed contribution rate irrespective of a member's age or seniority. Uniform contribution rates were typically between five and nine% of covered earnings. Around 56% of schemes, accounting for 23% of total coverage, varied the contribution rate with age, seniority or both. The remaining funds either did not require employee contributions or used different, in particular mixed systems.

33. The minimum rate of return was four% from the introduction of the compulsory system in 1985 until the end of the year 2000. This rate appears to have been based on one or other implicit assumption. Queisser and Vittas (2000), for example, argue that four% is approximately the long-term growth rate of nominal earnings. Hepp (1998) suggests that this is a little below the long-run return on Swiss government bonds. Since the beginning of 2003, the minimum rate of return is set at 3.25%. Because of the minimum return, the compulsory element of occupational pensions has been described as one of 'defined credits'. This defined-credit system has much in common with a defined-benefit scheme based on lifetime average earnings (revalued at the 4% statutory rate). Indeed, projected benefits under the Swiss scheme look similar to those under the 'notional-accounts' systems recently introduced in Latvia, Poland and Sweden.[6] The difference with these schemes, however, is that the Swiss system is pre-funded. It is therefore more akin to so-called 'cash-balance' schemes, which have grown in importance in employer-based pension plans in the United States.[7]

34. The government also specifies a minimum annuity conversion rate of at least 7.2% at the standard pension age. Thus, with a complete contribution record, the mandatory occupational pension on retirement is 36% of co-ordinated earnings for men (that is, 500x7.2%) and 34.5% for women (479x7.2%). Added to the public pension entitlement, this should result in a total pension replacement rate of 60 to 70% of pay. Unfortunately, there are no detailed data on projected mortality rates of compulsory and voluntary annuitants and inflation adjustments, so it is not possible to assess the actuarial fairness of the statutory annuity factor. Despite fluctuations in interest rates and the persistent increase in longevity, the conversion rate has not changed since 1985, but it will be cut to 6.65 over a period of 10 years starting in 2003.

35. Finally, there is a requirement that employers at least match employees' contributions. In 1997, employers made 63% of total contributions, rather more than the mandatory minimum of 50%.

36. Occupational scheme design – including the choice between defined benefit or defined contribution formula – is discretionary, so long as the scheme can show its compliance with the minimum

6 See Disney (1999).

7 See Schieber, Dunn and Wray (1998) and Koski (2000).

requirements are fulfilled. In 2000, the vast majority of funds – covering 76% of members – were defined contribution (Table 4). Furthermore, there appears to have been growth in the coverage of defined contribution schemes over time. For example, the plans of the federal government and canton and city of Zurich – covering some 65 000 members – recently converted to defined contribution for new employees.[8]

Table 4. Pension plan type, 1987 and 2000

Percent of total	1987		2000	
	Funds	Members	Funds	Members
Defined benefit	13	32	15	24
Defined contribution	84	57	84	76
Other	3	11	1	
Total	8 427	3.25m	3 418	3.23

Source: Pension Fund Statistics, Federal Office of Statistics, Vorsorgeforum 2.Säule

Note: the fall in the number of funds with active affiliates is overstated because the 1987 data include 2 278 frozen funds, which were excluded from later surveys

37. It is important to note that defined benefit plans typically aim for higher replacement rates than the statutory target minimum. Around 80% of members are in schemes that promise a replacement rate ranging from 60 to 74%. Similarly, Harris (2000) reports typical accrual rates of between 1.5 and 1.75% a year, giving a 60-70% replacement rate after a full career.[9]

1.4 Supervision

38. Supervision of occupational pension schemes is fragmented. Cantonal authorities are responsible for funds within their borders, although the Federal Office of Social Insurance supervises pension funds operating on a national level as well as the pension funds of Federal government bodies. The Federal Office for Private Insurance supervises life-insurance companies, which manage pension funds under collective insurance contracts, and approves the tariffs applied by the life-insurance companies. The Federal Council of Switzerland and the Federal Office of Social Insurance exercise top-level supervision. There is also an advisory Federal Commission on Occupational Pensions with representatives from federal and cantonal governments, employers, employees and pension funds.

39. Fragmented supervision gives rise to differences in supervisory practice, especially between the cantonal and national levels. However, the reliance of the supervisory authorities on external auditors and certified pension experts, who are legally obliged to report infractions, is of greater practical relevance. The Federal Office of Social Insurance can issue inspection guidelines to the relevant supervising authority but most supervision instructions are not very specific. The supervisory authorities' task is made more difficult by the fact that pension funds only need provide annual written reports several months after the end of the calendar year rather than ongoing, more regular reports. Thus, a sharp deterioration in the financial position of a pension fund might only be discovered after six to 18 months.

40. Funds' ability to deviate from the quantitative investment restrictions weakens the supervisory system. Small funds in particular often depart from accepted prudent practice and are the least able to bear the higher risks. Now that pension funds are able to invest in more volatile assets, such as derivatives, there

8 Wheelan (2000).

9 See also Anthony and Ort (1999).

is an increased risk that sudden large losses can occur but remain undetected for a long period. Finally, the lack of effective internal or external custody requirements allows scope for misappropriation or misuse of pension fund assets by unscrupulous employers and fund managers. Recent years have witnessed a growing number of cases of malpractice, although they remain rare and total losses are still small.

2. Member choice in pensions: portfolios

41. Investment choice within the Swiss occupational pension sector is currently extremely limited. Although there are no detailed empirical data, anecdotal evidence suggests that only a few large funds offer their members portfolio options. Indeed, many of the larger funds retain a defined benefit formula. In such plans, the issue of member investment choice is not relevant since the employer alone is responsible for financing of a certain benefit promise given to the employee. However, as we noted above, there has been a significant trend towards the defined contribution model. This trend is expected to continue in Switzerland; it has also been pronounced in other countries.[10]

42. The defined contribution schemes in Switzerland that currently offer investment choices do so only for contributions above the statutory minimum. Plan members can exert some influence on the portfolio allocation of their occupational fund but this can only occur through their representatives on the pension fund board. More importantly, this can only be achieved collectively, in the sense that the asset allocation is changed for all members. It does not, therefore, allow for portfolios to reflect differences in preference between members.

43. For example, one large Swiss scheme allows members to choose between two different investment options. Members can choose between a ‘risky’ fund, with a 50% allocation to equities, and the default fund, with a 25-30% equity portfolio share. However, this option only covers contributions above an earnings floor, which applies to around a quarter of the plan’s 8 000 total members. Around one half of eligible members have taken advantage of their option to choose. Pension fund managers have reported that it has been difficult to obtain regulatory approval for even this limited degree of choice. This partly results from the fragmented supervisory structure, which we described above, but also from regulations imposed by the income-tax authorities.

2.1 Why allow members more choice in portfolio composition?

44. The potential for higher returns from a more diversified portfolio (with a greater equity component) and the avoidance of excessively concentrated risk provide one set of arguments for member choice of investment portfolio. However, it is not the main one. As we argued at the beginning of the paper, choice is important because people have different preferences over their life-course. Swiss workers cannot choose the portfolio that best suits their age, career earnings path, expected retirement age and their attitudes to risk. For example, younger workers generally have few assets other than their human capital (*i.e.* their future earnings). It is optimal for them to hold assets with a low correlation with their projected

10 The trend away from defined benefit to defined contribution schemes in the United States has long been documented: see, for example, Kruse (1991) and Gustman and Steinmeier (1992). It is a more recent phenomenon in the United Kingdom (Disney, 1995; Disney and Stears, 1996) but is widely expected to gather pace, particularly after the introduction of stakeholder pensions. See also Kelly (1999) and Betson (1999) on general trends.

wages.[11] Past empirical evidence shows that aggregate wages have a small or zero covariance with equity returns.[12]

45. It might also be better for younger workers to weight their portfolio towards equities, which have a higher long-run return but also a higher short-term risk. Older workers, in contrast, should prefer a less risky, bond-weighted portfolio.[13]

46. Furthermore, workers of a given age will also vary in a range of characteristics, such as their occupation and industry and their family type, which affect their attitudes to risk. For example, the variability of individuals' earnings differs between occupations and industries. This will have an impact on people's best options for investing their retirement savings.[14] People might also want to retire at different ages.[15] In addition, people differ in the types of other (non-pension) assets that they hold: housing, durable goods and liquid assets, such as equities, bonds or deposits. Again, attitudes to risk and optimum investment strategies are likely to vary between individuals holding different non-pension assets. A 'one-size-fits-all' asset allocation means workers are unable to reap the benefits of diversification.

47. But there are also important counter-arguments to portfolio choice: principally, the cost and complexity. Dividing individual pension contributions between different funds (even when they are offered by the same manager) and transferring investments between funds on members' request can add significantly to the administrative burden. Providing information on different investment options and educating workers about investment choice might also be costly. There is also the risk that workers make the 'wrong' choices. Some studies of member-directed investment in 401(k) plans in the United States have argued that people exhibit 'reckless conservatism', investing the majority of their fund in low-risk, low-return instruments.

48. There are two main potential ways of expanding member choice of investment to ensure an adequate degree of matching between investor preferences and their pension fund portfolio. The first would be to allow members to opt out of their employer plan and choose a portfolio and fund manager from a range of competing financial institutions. The second approach is either to allow or to force existing occupational schemes to offer some degree of choice.

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11 See Jagannathan and Kocherlakota (1996). This is one of the main attractions of defined-contribution plans over defined-benefit which also tie the worker's pension to future earnings. See Disney and Whitehouse (1994, 1996) and Bodie, Marcus and Merton (1988).

12 Palacios (1998). Aggregate productivity growth is also an important factor in individual wage growth.

13 See, *inter alia*, Samuelson (1989*a,b*) and King and Dicks-Mireaux (1982). Constantinides, Donaldson and Mehra (1998) suggest that liquidity constraints prevent younger workers from investing as much as they should in equities. (A defined-contribution pension plan with member portfolio control could mitigate this problem relative to alternative schemes.) Younger workers' investment behaviour, in turn, might help explain the 'equity premium': the excess risk-adjusted return on equities compared with short-term government bonds. (Siegerl and Thaler, 1997 provide an accessible survey of the literature on this topic; see also Blanchard, 1993 and Mehra and Prescott, 1985.)

14 See, for example, Davis and Willen (2000).

15 Bodie (2001) shows that workers who are willing to delay retirement should increase their equity portfolio weighting relative to workers who definitely want to retire at a certain age.

49. Before discussing these two models in detail, however, we provide an overview of current pension fund portfolios in Switzerland as necessary background information for the discussion of expanded member choice.

2.2 Current pension portfolios in Switzerland

50. Total assets of Swiss pension funds have grown from the equivalent of 36% of GDP in 1970 to 121% of GDP in 2000.[16] Over the past decade or so, Swiss pension funds have steadily increased both equity and foreign investments (Table 5). Total equity investments rose from seven% of assets in 1987 to 34% in 2000, while foreign assets reached 29% of the total.

Table 5. Pension funds' asset allocation, 1970-2000

percent of total assets	1970	1980	1987	1992	1994	1996	2000
Domestic							
Liquid assets	7.0	6.0	9.1	8.3	7.1	9.5	7.3
Bonds	25.0	28.0	30.2	24.2	21.3	19.7	17.2
Loans				4.1	2.5	1.8	1.8
Mortgages	15.0	10.0	7.6	9.2	8.3	7.0	5.0
Property	16.0	18.0	17.3	17.1	17.0	15.5	12.2
Claims on employers	33.0	27.0	16.6	14.7	12.3	10.2	5.1
Employer equity					2.5	2.4	1.1
Equities	3.0	9.0	7.9	8.3	10.1	11.4	17.7
Foreign							
Bonds (Swiss Francs)				4.1	3.0	3.3	4.2
Bonds (other currencies)				4.9	7.0	8.0	9.6
Equities				2.5	5.3	7.6	15.1
Indirect investments			5.8				
Other	1.0	2.0	5.5	5.1	3.6	3.0	2.6
Totals							
Total equities	3.0	9.0	7.9	10.8	17.8	21.4	33.9
Total foreign				7.4	12.3	15.6	28.9
Total claims on employers	33.0	27.0	16.6	14.7	14.8	12.7	6.2
Total assets/GDP (percent)	35.8	45.5	64.2	75.0	82.8	95.2	121.5

Note: Indirect investments allocated to their respective asset classes in 1992, 1994, 1996, and 2000

Source: Davis (1995) for 1970 and 1980, Pension Fund Statistics, Federal Office of Statistics, Federal Office of Social Insurance

51. Nevertheless, equity holdings remain much smaller than other countries with sizeable pension funds. For example, equities make up 78% of pension fund portfolios in the United Kingdom, 62% in the United States and 41% in Australia. Argentine and Chilean funds hold around 28% of assets in shares (Table 6).

16 Helbling (1991) charts the longer term growth of the sector, reporting assets of occupational pension funds of 31% of GDP in 1942, 40% in 1970 and 65% in 1984.

Table 6. Pension fund portfolios, selected countries

(% of portfolio)	Equities	Fixed interest
United Kingdom	78	14
United States	62	27
Ireland	58	30
Australia	41	15
Belgium	40	46
Brazil	38	38
Peru	35	60
Canada	28	48
Chile	28	68
Sweden	28	62
Argentina	27	70
Denmark	27	63
Netherlands	26	63
Average	24	56
Luxembourg	21	61
Malaysia	16	55
Switzerland	14	69
France	14	38
Hungary	14	19
Austria	13	71
Greece	10	53
Finland	9	61
Portugal	9	27
Germany	8	74
Italy	8	63
Spain	5	76
Singapore	0	70
Mexico	0	96
Uruguay	0	100

Source: Srinivas, Whitehouse and Yermo (2000), De Ryck (1998), Asher (1998)

52. One potential explanation for the asset allocation of Swiss pension funds is the quantitative restrictions on portfolios. Until 1985, for instance, investment in foreign equities could not exceed 10% of assets and could only include foreign equities listed on a Swiss stock exchange. The requirement for a Swiss listing was lifted in 1985 and the ceiling increased to 25% in 1989. Nevertheless, the portfolio limits have not been binding in aggregate because most funds have invested more conservatively than the quantitative restrictions require. Also, the supervisory agency can give exemptions from the quantitative limits on application, provided the fund can prove satisfactorily its ability to manage more risky assets. Funds can even give their justification for deviations from the limits ex post.[17] Furthermore, these rules were relaxed in April 2000, when funds were permitted to set their own investment strategy without referring to the supervisor. Since the regulatory limits on investments have probably rarely been binding,

17 In this case, the funds remain subject to general investment regulations, which stipulate that assets are managed prudently to achieve a reasonable return, diversify risks and maintain a suitable degree of liquidity.

there must therefore be other influences on asset allocation: Box 1 argues that valuation and accounting rules have had a powerful effect.

53. The current asset allocation limits in Switzerland, however, do not prevent excessive concentration of risks and inefficient practices. Small pension funds can put all their assets on deposit with a single bank or invest them in a single mortgaged property. Claims on sponsoring employers are permitted to a much greater extent than in Anglo-Saxon countries.[18] Public-sector funds still held nearly 60% of assets in employer claims in the mid-1980s (Hepp, 1990) and over 30% in 1996 (FOS, 1998). These often arose from contribution arrears. This essentially restricts further the degree of pre-funding of liabilities, in addition to the permitted under-funding of 25%.

Box 1. Rules for valuing pension fund assets in Switzerland

Permitted valuation methods include purchase or book value, adjusted book value, nominal value, yield-equivalent value, market value, and average market value. Hepp (1990) found that the most common methods used were the lower of book or nominal value for fixed-income securities and the lower of book or market value for equities and other assets. Under this approach, investment income includes interest and dividend income but excludes unrealised capital gains.

These valuation rules are extremely conservative and have distorting effects on investment policies and financial reporting. Coupled with the requirement that pension funds can meet their obligations at all times (equivalent to a minimum funding requirement), they discourage equity investments and the use of market valuations for equities and other volatile assets in favour of bond portfolios, which generate regular income and have more stable values. Conservative valuations tend to create large hidden reserves and understate the true share of equities and other assets, such as property, in pension fund portfolios. This also undermines the quantitative restrictions, since the true exposure to individual assets or asset classes can be understated.

Pension funds' valuation practices have changed in recent years. A survey of 240 large pension funds found that 46% of used nominal values for bonds, while 33% used market values and only 15% used the lower of the two (Robeco, 1998). Over 70% of pension funds used market values for equities, while just 15% used book values.

Other countries have stricter rules regarding the valuation practices of pension funds: see, for example, Laboul (1998) and Demarco, Rofman and Whitehouse (1998).

54. The fact that Swiss asset limits are not binding suggests that there are other causes of relatively poor investment performance over the long term and, particularly, of smaller funds. There are two potential explanations.

55. First, the specified minimum return has become a 'norm' and encouraged policies that minimise the risk of a shortfall in any particular year.

56. Secondly, there has been little member pressure for higher returns, probably because of the system's structure. Given their conservative investment policies, it is not surprising that Swiss pension funds' investment returns are relatively low (Table 7). Indeed, returns on pension funds in countries with

18 In practice, however, their share of assets in private-sector funds has fallen from over 25% in the 1940s to under five% since the mid-1980s

quantitative limits on asset allocation tend to be lower than those with 'prudent-person' rules.[19] Returns in Switzerland were also lower than other countries with asset limits.[20]

Table 7. Returns on pension funds and balanced portfolios

Annual average, real,%	Actual returns 1984-96	Actual returns 1984-93	Balanced domestic Portfolio
Switzerland	4.0	4.4	2.0
Other countries with asset limits	6.5	6.9	4.0
Belgium	9.0	8.8	4.2
Canada			2.2
Denmark	6.0	6.3	5.3
France			5.2
Germany	7.0	7.2	6.1
Italy			1.9
Japan		6.5	5.5
Spain		7.0	
Sweden		8.1	3.8
Countries with prudent-person rules	9.5	9.5	3.4
Australia			2.7
Ireland	11.0	10.3	3.8
Netherlands	8.0	7.7	4.5
United Kingdom	10.0	10.2	3.8
United States	9.0	9.7	2.1

Note: balanced domestic portfolio is 50% bonds, 50% equities
Source: OECD (1998), Tables V.2 and V.3, based on European Federation for Retirement Provision (1996), Pragma Consulting, Davis (1998)

57. Larger plans are often defined-benefit, so the pension value does not depend on investment performance because employers assume most of the investment risk. Low-income workers receive most of their pension from the public scheme, because only earnings above a minimum are covered by occupational plans. Again, therefore, they are little affected by low returns. The minimum annuity

19 See also the discussion in European Commission (1999) and Srinivas, Whitehouse and Yermo (2000). Unfortunately, there are no comprehensive data on the interest rates credited to 'notional' individual pension accounts, which are a crucial determinant of the value of pension benefits and transfer values.

20 Note, however, that more recent data from *Pensions and Investments* show that real returns for large Swiss pension funds were much closer to the returns earned in other countries. Between 1995 and 1998, large Swiss funds' returns averaged 12.1%, compared with 15.5% in Canada, 13.1% in the United Kingdom and 16.2% in the United States. However, larger pension funds appear to have much more diversified portfolios than smaller. Watson Wyatt (2000) reports a 44% equity share among larger funds (with assets over SFr 10m million).

conversion factor and minimum return offer security to members of all types of plan.[21] Domestic criticism of pension funds has tended to focus on vesting and portability rules rather than low fund returns.[22]

2.3 International experience in portfolio choice

2.3.1 United States

58. The United States provides a useful example of employer pension plans offering members investment choice. The fastest growing form of employer pension provision has been through 401(k) plans, named after the relevant clause of the income-tax code. These are defined contribution schemes.

59. Table 8 shows how member investment choice in 401(k) plans has expanded since 1978. In that year, only 16% of members were offered some choice over how their own contributions were invested. Just 10% had some control over their employer's contributions. However, nearly all schemes offered choice over investments for employee contributions by 1994. Three-quarters of members could also choose how their employer's contributions were invested. At the same time, there has been a shift from defined benefit to defined contribution schemes. The United States Department of Labor (1997) found that coverage of defined contribution plans expanded from 14% of the labour force in 1975 to around 37% two decades later. Coverage of defined benefit schemes declined from nearly 40% to around 25% over the same period. Defined benefit schemes obviously can not (and do not need to) offer portfolio choice.

60. Within the defined contribution sector, there has also been an increase in the range of investment options. A survey of nearly 750 employers in 1996 found that the average number of investment choices was 7.7, nearly double the number offered just six years earlier.[23]

61. The main conduit for this expansion of choice has been through the interpretation of fiduciary-duty legislation. Section 404(c) of the Employee Retirement Income Security Act specifies that employers are not liable for investment performance when they provide participant choice, which is defined as at least three options with materially different risk-return characteristics. In addition, the plan must allow members to switch investments at least quarterly and ensure that members can make informed portfolio choices (see below).

21 As noted previously, this introduces a substantial defined-benefit component into schemes that are nominally of the defined-contribution type.

22 Note that insurance companies offer bonuses if investment returns exceed those that were used for calculating the uniform premiums for insured pension funds. However, workers' legal right to any returns above the minimum is not clear.

23 Foster Higgins (1996). See also General Accounting Office (1997) on this trend.

Table 8. Broadening choice in defined contribution plans in the United States

percent of plans	1978	1994
Investment choice		
Employee contributions	16	94
Employer contributions	10	74
Number of investment choices		
One	51	12
Two	28	7
Three	13	9
Four	4	15
Five or more	4	58

Source: Schieber, Dunn and Wray (1998) based on data from the Profit Sharing Council of America

62. Table 9 shows the types of choices offered in defined contribution pension plans in the United States. The data are drawn from a survey of nearly 750 employers with a defined contribution pension plan, of which 90% were 401(k) plans. The Table confirms the breadth of investment options typically open to members of pension funds in the United States.

Table 9. Investment options in defined contribution plans in the United States

Investment option	percent of funds
Guaranteed investment contract/deposit	59
Equity, actively managed growth	78
Equity, actively managed core	36
Equity, indexed	42
Equity, international	56
Money-market/short-term fund	58
Company stock	26
Balanced fund	74
Bond fund	60

Source: Foster Higgins (1996)

63. Finally, there has also been a trend in the United States to allowing pension fund members the opportunity to make more frequent investment choices. Hewitt (1997) reported that 64% of plans now allow members to transfer their investments daily, compared with 41% in the 1995 survey.[24]

2.3.2 Australia

64. Australia is also moving in the direction of greater member direction of investments. The superannuation guarantee – a system of defined contribution pensions with mandatory employer contributions – was introduced in Australia in 1992. Since membership is compulsory, this offers a rather closer parallel to Switzerland than 401(k) plans in the United States. The latter are voluntary in the senses both that employers do not have to offer schemes and that employees do not have to join them.

24 Similarly, Buck Consultants (1997) find 61% of plans now offer daily switching.

65. The Australian Prudential Regulatory Authority argues that member investment choice recognises ‘that funds contain people of differing ages, financial needs and attitudes to investment risk’. The unified financial supervisory agency also says that ‘the government considers that increased choice, including in relation to investment strategy, increases competition and benefits members’.[25]

66. Over half of superannuation guarantee members had some kind of investment choice by 1996-97. The degree of member choice has been expanding rapidly. Some 60% of contributions in 1996-97 were paid into funds with investment choice, compared with 53% the previous year and just 46% in 1994-95. There has also been an expansion of the number of options offered by funds with member choice – from 5.8 in 1994-95 to 6.2 in 1996-97 – but this has been much slower than the growth in the United States.[26]

67. Current policy in Australia has tended to link member choice of portfolio with choice of superannuation fund. The latest draft legislation, for example, would require employers to comply with one of three models:[27]

- Limited choice of at least four funds, which must consist of at least one public-offer fund and at least one retirement savings account (a type of deposit), and an industry fund and an in-house corporate fund if they exist under current arrangements;

- Unlimited choice, where employees nominate their preferred fund; or

- Negotiating an agreement covering superannuation between employees and employers.

68. However, this has yet to gain legislative approval.[28]

69. Finally, anecdotal evidence suggests that superannuation plans that offer investment choice typically allow members to alter portfolios twice a year at no cost, but charge a switching fee of around one% for more frequent changes. This is rather less flexible than the position in the United States described above.

2.3.3 Other countries

70. The move towards increased member choice of investment portfolios is widespread internationally, including countries outside of the OECD.

71. Singapore has substantially liberalised investment opportunities in its Central Provident Fund (CPF) system in a series of reforms beginning in 1996. The Central Provident Fund is a mandatory defined-contribution pension system of individual accounts, which are managed collectively by a public agency. [29] Members can opt to invest some of their balances in equities (approved by the CPF) directly or via unit trusts (mutual funds). The latter are now permitted to invest up to half of their assets overseas in approved countries (six of the richer East Asian countries plus the United Kingdom and the United States). Even by 1997, over 55% of people eligible for the so-called CPF Investment Scheme had taken advantage

25 Australian Prudential Regulatory Authority (1998), page 13.

26 Australian Prudential Regulatory Authority (1996, 1997, 1998).

27 See Bateman and Piggott (2001) for a discussion.

28 See also the discussion in Senate Select Committee on Superannuation (1995).

29 See Asher (1999) for a detailed description.

of their freedom to choose and nearly 45% of eligible balances were so invested. The most recent reforms have liberalised the regulation of unit trusts by relaxing quantitative investment restrictions and improved disclosure and transparency. The CPF has also implemented an extensive public information campaign. This includes both an education programme to improve consumer financial literacy and publication of 'league tables' of unit trusts' asset diversification, risk and performance.

72. In two other OECD countries, Poland and Mexico, member choice is also increasing. Poland recently introduced a system of individual retirement-savings accounts that is mandatory for people under 30 and optional for people aged between 30 and 50.[30] Currently, managers are permitted to offer only a single pension fund. However, the regulations allow for two funds from 2005: one with a relatively liberal investment regime, the other restricted to fixed-income securities. In Chile, pension fund members are now allowed to choose between 5 different types of funds which vary according to the share of equities in the portfolios. There are also default funds for members who do not care to make such choices; these default funds target different age groups and are invested accordingly, *i.e.* with declining shares of equity investment as members approach retirement age.

73. In Mexico, the regulations also contemplate allowing more than one fund some time in the future.

2.3.4 Evidence of members' behaviour when offered portfolio choice

74. Some evidence on how members react to expanded choice comes from the United States. The retirement confidence survey, collected by the Employee Benefit Research Institute, found that 44% of people insisted that they would invest with no more than minimal risk to their retirement savings. A further 32% preferred a strategy of average risk and average gain.[31]

75. Table 10 explores this issue empirically. It shows the allocation of 401(k) investments from a large survey covering 18% of 401(k) members.[32] Overall, nearly 70% of funds are invested in equities, with 15% in bond or money-market funds and 15% in guaranteed investment contracts.

30 See Chlon, Góra and Rutkowski (1999).

31 Yaboboski (1995).

32 VanDerhei *et al.* (1999). Earlier studies used rather smaller data sets. These include Yaboboski and VanDerhei (1996), who looked at 180 000 members with three large employers. Goodfellow and Schieber (1997) analysed 36 000 participants in 24 schemes. See also Holden and VanDerhei (2001), Sundén and Surette (1998) and United States General Accounting Office (1996, 1997). Other papers have investigated investment choices in the Thrift Savings Plan (a defined-contribution scheme for federal employees) — Poterba and Wise (1996) and Hinz, McCarthy and Turner (1997) — and in TIAA-CREF (a plan for teachers and college professors) — Ameriks, King and Warshawsky (1997).

Table 10. Asset allocation in member-directed 401(k) pension plans

	Equity	of which, own employer's stock	Bond/money funds	Guaranteed investment contracts
20	77	22	14	8
30	76	26	14	9
40	72	29	14	12
50	67	29	15	16
60	53	28	18	26
Total	68	28	15	15

Note: investment in balanced funds is allocated 60% to equities and 40% to bonds, in line with the Investment Company Institute's data for the average balanced mutual fund
Source: VanDerhei et al. (1999)

76. The portfolio pattern against age seems broadly prudent, an allocation which Yaboboski and VanDerhei (1996) describe as 'workers matching their investment patterns with their time horizons in a textbook manner'.[33] Older workers tend to reduce the proportion in equities and increase the allocation to more stable investments, such as bond and money-market funds and guaranteed investment contracts. These contracts, provided by insurance companies, provide for a 'holding period' during which a fixed rate of return is paid, guaranteed for the life of the contract. Withdrawals can be made at book value to provide benefits.

77. There are, however, some important divergences from prudent investment. First, the large allocation to the stock of the employer: 28% of the total invested in equities or 19% of the total fund. A more diverse portfolio would be more sensible. Indeed, given individuals' future employment and wages are already dependent on the performance of their employer, any investment in the employer's stock seems imprudent. However, this allocation does not typically result from member choice. Company stock is often offered as part of the employer contribution or of an arrangement combining the 401(k) pension plan with a profit-sharing plan. In 1997, for example, 21% of the 401(k) plans where employers made matching contributions provided company shares as all or part of their contribution.

78. Secondly, a substantial minority of scheme members appears to be very conservative. Fifteen% of people have no equity investments at all, even through balanced funds or their own employer's stock. Although this may be a rational strategy for people in their 60s (25% of whom have no equity investments), it is almost certainly not for people in their 20s (of whom 15% avoid equities). More detailed analysis of this group, however, reveals that most are new to their jobs. It seems that people are willing to join their employer plan when young and starting a new job, but they delay making investment decisions for a couple of years.[34]

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33 Furthermore, 401(k) members appear to have shifted to less conservative investments over time. Samwick and Skinner (1998) report that the proportion investing mainly in equities increased ten percentage points between 1989 and 1995. This may result from the success of member education programmes: see section 2.3.5.

34 This 'procrastination' has been explained by Akerlof (1991) and O'Donoghue and Rabin (1999) by the fixed cost needed to acquire the information to make investment decisions relative to the loss from short-term delays. Nevertheless, member education programmes have been shown to be effective in offsetting this effect in pension plans (section 2.3.5) and to have beneficial effects on wider household savings and investment decisions (section 2.3.6).

79. There is also evidence that members of 401(k) plans vary their investment decisions depending on the other assets they hold. Uccello (2000) shows, for example, that people with a defined-benefit occupational pension plan in addition to their 401(k) scheme invest somewhat more aggressively. A higher proportion has equity-dominated 401(k) portfolios than people for whom their 401(k) is their only pension scheme.

80. The final potential risk is that people 'churn' their pension portfolio excessively. This risk has been increased by the trend to allow members to change their investment choices more frequently (see the discussion at the end of section 2.3.1). Barber and Odean (2000) and Odean (1999) argue that individual investors trade too much and that their trading behaviour reduces their investment returns. However, Agnew, Balduzzi and Sundén (2000) show that members of a particular 401(k) plan churn their portfolios much less frequently than the investors with self-directed brokerage accounts studied by Barber and Odean. They found that people changed their portfolio allocation only once every 3.85 years. This is consistent with models of optimal portfolio choice in the presence of transaction costs.[35]

81. In conclusion, the evidence from the United States is encouraging: the majority of defined-contribution scheme members make prudent investment choices.[36] Moreover, Papke (1998) finds that member choice of portfolio is associated with a five percentage point increase in contribution rates and more diversified investments than schemes where employers direct investments. Members of pension plans in the United States take advantage of the flexibility schemes offer to adjust their portfolios to suit their particular circumstances (most importantly, how close they are to retirement). Portfolio choice would also benefit members of pension schemes in Switzerland, although the most significant benefits would probably accrue to younger workers. They would benefit from the option to have a higher-risk, higher-reward portfolio.

2.3.5 The role of member education

82. A crucial issue for the success of expanded member choice is the availability and accessability of financial information. Plan members need to understand the implications of their current portfolios and the potential consequences of making other investment decisions. For Switzerland, this issue is particularly important. As the current structure of the occupational pension system relies entirely on the employer, plan members are not used to gathering and processing the necessary information on the plan's investment and performance. In fact, reliable information on the returns of the individual plans are not even available to the system's supervisors. If Switzerland were to give more choice to workers, substantial efforts would have to be made to provide more and better information on investment, performance and alternative portfolios.

83. The experience of the United States is encouraging in this respect as it shows the apparent success of workplace financial education about pension options. These education programmes have become much more widespread since the expansion of member choice. As with member investment choice

35 See, for example, Lynch and Balduzzi (2000).

36 It is also worth noting at this point the experience of other countries that have offered individuals choices over their pension provision. Most countries introducing a fundamental pension reform have allowed at least some of the workforce to choose between remaining in a reformed public pension system or switching part of their contribution to an individual pension account. Take-up rates among the groups that would expect to benefit most from the switch to the funded option have been higher. See Palacios and Whitehouse (1998) and Disney, Palacios and Whitehouse (1999) and the references therein.

in itself, member education programmes result, at least in part, from the interpretation of employers' fiduciary duty to 401(k) members. In addition, most employers favour these devices for their positive effects on plan participation, contributions levels, and portfolio decisions.[37] The Foster Higgins (1996) survey of defined contribution plans discussed above reported wide use of different member education mechanisms, as follows:

- summary plan descriptions, 97%;
- newsletters or brochures, 91%;
- fund prospectuses, 88%;
- personalised statements, 86%;
- employee meetings, 91%; and
- integrated voice response systems, 61%.

84. Nearly three-quarters of members said they had received some educational material about their employer pension plan, according to a survey by the Employee Benefit Research Institute.[38] Of these, over 90% said they had read the material. In addition, employees reported that the education programme had led to them changing their pension saving. A third said they had increased their own contributions to the plan and 44% said that they had changed their asset allocation.

85. Detailed behavioural analysis confirms these attitudinal results. Table 11 shows the results of a study of the effects of retirement-preparation seminars offered by employers.[39] Controlling for a range of other characteristics, the proportion of employees joining the plan increased by about eight percentage points. The effect was concentrated on workers with low and medium earnings. Workplace education also appears to increase the average contribution rate by around half a percentage point. Again, the effect on lower earners was larger.

Table 11. Effect of workplace retirement seminars on participation and contribution rates to pension plans

Percentage points	All	Low/mid earnings	High earnings
Participation rate (percent of employees)	7.7-8.2	11.5-12.1	6.4-6.6
Contribution rate (percent of earnings)	0.4-0.7	0.8-1.1	-0.1-0.3

Note: Numbers in bold are statistically significant. Two estimates shown relate to models with and without firm-specific fixed effects

Source:Bayer, Bernheim and Scholz (1996). Data from KPMG Peat Marwick survey of employer pension plans

86. Bernheim (1998) carried out a small survey of 200 401(k) plans. He found that education programmes alone increased participation rates by 19%. The results also showed that more regular education efforts were more effective. Participation increased by 25% with high-frequency programmes, compared with just 13% for low-frequency. Employer matches of member contributions were, perhaps unsurprisingly, more effective at increasing participation. However, it is interesting to note that an improvement in the terms of the employer contribution match had less of an effect than an increase in the

37 The government of the United States also imposes complex rules on non-discrimination in occupational pension plans. These are designed to avoid employers setting up schemes that benefit only senior management. Thus, employers can be in a position where they need to increase participation among low-income workers to comply with these regulations.

38 Milne, VanDerhei, and Yakoboski (1995, 1996).

39 See also Bernheim and Garrett (1996) on this issue.

frequency of education efforts (a five% increase in participation compared with 12%). Table 12 shows similar results from a survey of 19 large 401(k) plans.[40]

Table 12. Effect of workplace education and employer matching of contributions on 401(k) participation

Percentage point increase	Participation rate	Contribution rate
Match of employee contribution (base: 25%)		
50-75%	28	0.8
100%	47	2.0
Communications		
Generic information	15	0.0
Plan-specific information	21	2.0

Source: Clark and Schieber (1998) based on Watson Wyatt survey of 19 plans with around 60 000 employees

87. Obviously the case of the United States is not directly comparable to Switzerland where the participation in occupational pension is compulsory for the majority of workers. But this example still shows that education campaigns can be highly effective in increasing workers' financial literacy and making them more aware of their own interests in the management of pension funds.

88. It is easy to think of the need for educating pension fund members about different investment strategies purely as a cost to a system with portfolio choice. However, there is evidence that there are wider benefits from such programmes in terms of improved consumer financial literacy.[41] Weisbenner (1999) finds that members of defined contribution pension plans that offer portfolio choice in the United States invest their non-pension assets significantly differently than others. He attributes this effect, which holds even when controlling for other characteristics, to the educational effect of investment choice. This, of course, does not occur when employers make portfolio decisions (that is, in some defined contribution and all defined benefit plans).

89. Finally, Bateman and Piggott (2001) also stress the importance of public education and transparency when members are offered investment choice in their study of Australia. The government there has issued a consultation paper on these issues.[42]

2.4 A way forward for Switzerland

90. As mentioned above, we propose two potential models for expanding member choice of investments in Switzerland.

- The first model is a minimalist one. In this model, funds would be permitted (although not required) to offer members different portfolio options. The choice would cover both the mandatory contribution

40 See also Munnell, Sundén and Taylor (2000).

41 King and Leape (1987), for example, report that 40% of respondents told the survey of consumer financial decisions that they did not own equities because they did not know enough about the stock market. Member education in defined contribution pension plans and the more immediate opportunity to hold equities might address this problem.

42 Corporate Law Economic Reform Program (1999).

and any additional contributions. It would involve some amendments to the regulatory and supervisory framework to provide the appropriate safeguards for members.

- The second model would go further and require schemes to offer their members investment options with meaningfully different risk and return characteristics. Again, we spell out the regulatory pre-requisites for such a reform. In both cases, the current disclosure and information standards on occupational pension funds (see Box 2) would need to be improved. Indeed, we believe that there is a need for better reporting even without expansion of choice.

Box 2. Disclosure and information standards

Funds must produce annual reports and accounts and submit them to the supervisory authorities. They must inform members of their pension balance on request and at least every three years. Employees must be given detailed statements of the transfer value when they change jobs.

Nevertheless, Swiss pension funds provide little public information, compared, for example, with the requirements in Latin America. (See Demarco, Rofman and Whitehouse, 1999.). Biennial surveys of funds by the Federal Office of Statistics are published with a two-year delay, but they contain few data on investment performance and operating costs, with nothing on individual funds. Thus, workers have no way of comparing the performance of their own fund with other funds.

Because pension funds are employer-based, they do not compete for members. Fund managers, competing for management mandates from the pension funds, presumably market their services, but these campaign are aimed at employers and not at the general public.

Information to workers as well as training on how to use this information are crucial if Swiss workers are to be given more choice in investment decisions.

2.4.1 A way forward 1: optional investment choice

91. The most significant obstacle to expanded investment choice in the current system is the guaranteed rate of return required by the Swiss supervisors. It is, of course, possible to develop investment strategies that would at the same time both meet the guarantee and, with greater diversification across asset classes, offer a better prospective return. However, such strategies must necessarily use complex derivative instruments. These are expensive (in terms of transaction costs) and difficult to understand. Indeed, a number of very sophisticated investors have made costly mistakes in derivatives markets.

92. A more sensible strategy would therefore be to suspend the guarantee on investment returns in those cases where members choose to exercise portfolio choice. This would naturally not mean that workers would invest freely in whatever instrument they chose but it would entail a number of regulatory and supervisory safeguards to ensure prudent investment of the retirement funds. The requirements on pension fund trustees and/or service providers might include the following:[43]

- Demonstration of the administrative capability to deal with diverting contributions to different investment accounts and switching assets between them;

- Setting out a statement of investment principles for each investment option;

- Providing the information members might reasonably need to understand the potential risk of different choices;

43 This list draws on the regulations set out in Australian Prudential Regulation Authority (1999).

- Setting out the administrative charges for each investment option, the cost of switching between funds etc., and

- Provide a default strategy for members who do not wish to exercise portfolio choice that complies with existing regulations, including the guarantee.

93. We believe that these safeguards would be more than sufficient to protect members' interest while expanding the scope of investment choice. The regulations would not need in this model to specify the types of choices offered.44 Nevertheless, Box 3 sets out for information a useful typology of potential portfolios for defined contribution plans drawn from Pellish and Buehl (1996). While this was developed in the context of the United States financial system, it is applicable with some modifications to the Swiss case.

44 However, Benartzi and Thaler (1998) argue that the menu of portfolio options has an important effect on member choices. They find a relationship between the number of equity-based instruments offered on the menu and the proportion of assets invested in stocks. This so-called 'farming effect' has been found in a number of areas of consumer behaviour. These findings underline the importance of member education; perhaps they make a case for regulatory intervention in the menu of investment choices that plans may offer.

Box 3. A prototype for portfolio choices

The basis of any menu of portfolio choices is to offer investments with difference risk-return characteristics. This can be achieved even with the simple 'core options' prototype shown in Table 13. At the conservative end, this offers a stable value fund, which might be either a deposit or, in the United States, a guaranteed investment contract (as described previously). Moving down the Table, investments become, on historic experience, more volatile, but have offered better returns. A balanced fund, for example, might be split 50:50 or 60:40 between equities and less risky instruments, such as government or corporate bonds. The core options portfolio, however, does include pure equity vehicles. At the riskiest end, there is a fund investing in small-capitalisation domestic stocks.

Table 13. Three degrees of investment choice

Core options	Enhanced core	Full array	
Stable value			
	Money market	Money market	
	Diversified bond	Diversified bond	
	Conservative lifestyle	Conservative lifestyle	increasing risk and return
Balanced			
	Moderate lifestyle	Moderate lifestyle	
	Aggressive lifestyle	Aggressive lifestyle	
Large-cap domestic equity	Large-cap domestic equity	Large-cap domestic equity	
International equity	International equity	International equity	
Smaller-cap domestic equity	Smaller-cap domestic equity	Smaller-cap domestic equity	
		Emerging market equity	
		Self-directed brokerage	

Source: Based on Pellish and Buehl (1996)

The 'enhanced core' menu offers more options at the safe end: a money-market fund and a pure bond portfolio. This package also includes so-called 'lifestyle' funds. These aim to adjust portfolios automatically across the lifecycle: from a higher risk, higher reward portfolio when members are young to more stable investments when the member reaches retirement.

The 'full array' adds options at the riskier end. These might include emerging market equities and self-directed brokerage accounts, where individuals are able to pick their own stocks.

2.4.2 A way forward 2: mandatory investment choice

94. Opening the opportunity for pension funds to offer portfolio choice to their members does not, of course, guarantee that many funds would choose to do so. The result might therefore be that only a few workers gain additional choices. Furthermore, these workers might be those who are already members of the better occupational plans.

95. Anecdotal evidence from Switzerland suggests that a high proportion of pension-fund members that are offered different pension options take advantage of the choices. Furthermore, the mandatory pension system is not yet mature. This means that pension fund balances are continuing to grow, which in turn implies that investment choice will have a growing impact on the performance and volatility of pension investments. The experience of other countries suggests that this will result in increasing pressure for member portfolio choice. A number of Swiss sources have already reported growing political concern about this issue.

96. In the first instance, however, the impact of the first, optional model will depend on the willingness of employers and pension fund trustees to move in the direction of increased member choice. Thus, a more thorough reform would be to require funds to offer a series of portfolio options. This would, of course, require much more substantial regulatory and supervisory safeguards. In essence, the supervisory agency would need to ensure that all funds complied with the requirements set out in the bullet points in the preceding section.

97. It would therefore seem sensible to introduce voluntary investment choice (on the part of pension funds) first. The medium-term goal would then be to move to mandatory provision of portfolio options. The transition period between voluntary and mandatory provision of member investment choice would allow pension boards and sponsoring employers to prepare. The sector would probably consolidate, with smaller funds either joining multi-employer schemes or 'contracting out' plan management to financial-services companies. At the same time, a public-information campaign, in co-operation with employers, pension fund managers etc. would be needed to make members aware of the trade-offs involved in different choices.[45]

3. Member choice of pension fund manager

98. The previous section set out how Swiss workers might be offered a broader range of investment choices for their pension assets than they are given at present. This expansion of choice, however, would be achieved within the current structure of occupational pension plans. This section investigates a second approach to expanding investment choices: allowing members to choose their pension fund manager. This approach is being debated in Switzerland with a high degree of controversy.

99. The principal argument for this more far-reaching reform is the lack of competition in the existing pension system. People arrive at their pension fund manager as a by-product of their choice of employer. So they are essentially captive members of their employer's occupational plan. Even if individuals were perfectly informed, they would face a very complex choice between employers offering different pay and pension packages. The natural answer would be to untie pension provision from the employment contract and allow people free choice of pension fund manager. This would allow members to switch funds when they wanted, without having to change employer, and give them a much more direct influence on pension fund efficiency and performance. A further advantage is that second-pillar pension provision could be extended to groups not currently covered, such as workers on short-term employment contracts.

100. The main argument against such a fundamental reform in Switzerland relates to the issue of solidarity. In the current system, pension schemes provide several redistributive insurance services, for example for disability and survivors' pensions. A policy allowing workers to choose freely which fund to join is feared to undermine these "solidarity" elements and make insurance coverage more expensive for those who may be more vulnerable to risk. This argument holds true in defined-benefit pension schemes where the collective pooling in the scheme indeed enables redistribution. But in defined-contribution pension schemes this argument is not valid since the schemes are already individualised. Nevertheless, fears exist that allowing free choice of pension funds would accelerate the current trend of Swiss pension schemes toward defined-contribution rather than defined-benefit solutions.

101. Again, there would be a number of means of implementing a reform to achieve free choice. We have, however, rejected many of these options because they would quite probably lead to a dismantling of

45 See Whitehouse (2000*c*) and Chlon (2000) on the design of public-information campaigns in the United Kingdom and Poland respectively.

the current employer-based system. This would be neither necessary – most of the gains can be achieved with much less radical reform – nor desirable, given the obvious strengths of the present regime. Also, an important reason for employer-independent pension plans – the lack of portability – does not apply to Switzerland, where immediate vesting and full portability are mandatory. We explore, therefore, a policy of allowing members to opt out of their employer's occupational scheme into an approved plan offered, for example, by a financial-services company.

3.1 International experience

102. The most direct parallel for such a policy is the 1988 reform of the pension system in the United Kingdom. The main thrust of the reform was to allow people to divert part of their mandatory social security contribution from the public pension scheme to individual pension accounts.[46] However, most relevant here are the changes that affected the occupational pension sector.

103. The principle of 'contracting out' of the public pension plan was established in 1978, when the new state earnings-related pension scheme (known by the acronym, Serps) was introduced. This was felt necessary to avoid undermining the position of existing occupational schemes. Initially, opting out was only possible for employers providing defined-benefit plans. In 1988, the government extended the ability to contract out of Serps to defined contribution schemes, both occupational and personal pensions. At the same time, employees were allowed to opt out of their employer's occupational scheme. Until then, employers could make membership of the plan a compulsory part of the employment contract.

104. The government introduced the personal-pension option in 1988. It expected 0.5 million to take out a personal pension within two to three years, although a contingency plan allowed for up to 1.75 million participants. In fact, 3.2 million took out a personal pension in the first year, rising to 5.7 million after five years.

105. The introduction of a new, unfamiliar instrument in the already complex pension environment in the United Kingdom naturally ran the risk that people would make the 'wrong' choice. The resulting debacle of personal pensions mis-selling is well known internationally, but often not well understood.

3.1.1 Personal pension mis-selling in the United Kingdom

106. There were four main types of consumer who bought personal pensions inappropriately. First, older workers who, because of compound interest and complex transitional arrangements, would most probably have been better off remaining in Serps.[47] This feature of the pension system seems to be well understood and take-up rates among older workers were close to zero. The second mis-selling problem relates to administrative charges. Personal pension providers levy fees in up to six different ways. This hinders comparisons between providers. Individuals who start and stop contributions can lose out. In addition, some providers levy fixed charges, which mean that low-paid workers face a particularly large burden.[48]

46 As such, this change was similar to the earlier reforms in Chile and the subsequent reforms elsewhere in Latin America and in Central and Eastern Europe.

47 See Disney and Whitehouse (1992*a,b*), Dilnot *et al.* (1994), Whitehouse (1998) and National Audit Office (1991) for a discussion.

48 The issue of charges is a very complex one and space prevents a more detailed discussion here: readers are referred to Whitehouse (2000*a*, 2000*b*, 2001*a*).

107. More significant are the last two types of mis-selling case, where people took out a personal pension instead of an occupational scheme. Some people were eligible to join their employer's occupational scheme but did not and took out a personal pension instead. It is very difficult to work out whether, and by how much, people's pension rights were reduced as a result. The value of a defined-benefit pension depends on final earnings and on tenure in the scheme, neither of which is known ex ante. The main reason employees would lose by taking a personal instead of an occupational scheme is that they usually forgo the employer's contribution. However, unlike defined-contribution schemes, the benefits in occupational plans do not bear a direct relationship to the flow of contributions. Even with the loss of the employers' contribution, some younger workers who do not plan to stay long with their employer would be better off in a personal scheme, which is more portable between jobs.[49] One solution to this problem would be to make employers' contributions portable: *i.e.*, to require those who offer an occupational plan to make some contribution to personal scheme's taken up by their employees. Tying the employer's contribution to defined-benefit scheme is a significant restriction of individual choice.

108. In the other case, people had been members of an occupational scheme, usually in a previous job. The new regulations allowed people to transfer these so-called 'preserved' rights into a personal pension. People might lose from this transaction in three ways: because of administrative charges, poor investment performance or the actuarial assumptions used by the occupational plan's managers (over which they have considerable leeway).

109. The process of compensating in mis-selling cases has been a lengthy one: readers are referred to the various documents issued on the subject by the Financial Services Authority (www.fsa.gov.uk). There has been some criticism of this compensation, and not all of it from the industry paying it. Normal rules of caveat emptor, or 'buyer beware', appear to have been suspended. Buyers of other inappropriate financial products – such as 'low-cost' endowment mortgages or home-income plans – have found it much more difficult to obtain redress, as did the victims of the Maxwell occupational-pension fraud.[50]

3.2 Lessons for Switzerland

110. The experience of personal pensions in the United Kingdom shows that important safeguards need to be in place to ensure that members do not make the 'wrong' decisions when they are offered choice of pension regime.

111. Central to such protection is the issue of transparency. As we noted previously, it was very difficult to compare the value-for-money offered by different providers. The new 'stakeholder pension' – another type of defined contribution pension plan, operated mainly by traditional providers such as insurance companies, fund managers and banks – aims to fix many of the problems of personal pensions.[51] Instead of the plethora of different types of fees with personal pensions, stakeholder providers will be restricted to just one type of charge: as a percentage of assets. This gives consumers a single 'price' with which they can compare different products. A related initiative is the consumer-education remit enshrined in the legislation establishing the new unified regulator, the Financial Services Authority. The FSA will publish 'league tables' of the cost and quality of financial products, including pensions, as well as broader

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49 See Whitehouse (2001) and Disney and Whitehouse (1994, 1996) for a detailed discussion; also Blake and Orszag (1997).

50 See, *inter alia*, Lex (1998), Riley (1998) and Whitehouse (1998).

51 The reforms were set out in Department of Social Security (1998). See Disney, Emmerson and Tanner (1999) for an analysis and assessment.

projects to promote consumer financial literacy.[52] Together, these policies should increase the transparency of charges and empower consumers to shop around for lower-cost providers.

112. Furthermore, the government has capped the charge at one% of assets. Along with increased flexibility to stop, start and change the value of contributions, this should reduce administrative charges. This reduction is helped by workplace access to stakeholder pensions – which should reduce marketing costs – and simplification of the regulatory regime, particularly the complex taxation rules.

113. The second crucial policy is the rules setting out the terms on which individuals may opt out of their employer's occupational pension scheme. It is useful to return to the experience in the United Kingdom. As we noted above, one of the main reasons that people taking out a personal pension instead of an occupational scheme might be worse off was that they generally lost most of their employer's pension contribution.[53] Only 15% of personal pension plans receive an employer's contribution, and only five% of employers with an occupational scheme say they will pay into an employee's personal plan instead. Employers' contributions make up, on average, 70% of the flows into occupational schemes.[54]

114. In Switzerland, as in the United Kingdom, many occupational pension schemes offer benefits beyond the statutory minimum. If members were allowed to opt of their employer's plan but could only receive the statutory minimum contribution into their alternative plan, there is a risk that many would lose out. It would be possible to protect members from this in two ways:

- give employees the right to divert the whole of their employer's contribution to their chosen investment manager.[55] This was described in the PRASA report for the Federal Office of Social Insurance (2000) as the 'total compensation approach'.

- give employees the right to opt out of their employer's plan only if they can prove that their alternative arrangements are at least as good as the occupational scheme that they are leaving.[56] This would probably limit the contracting-out option to employees in plans that offer only the statutory minimum benefits or those whose employers were willing to make the equivalent contribution to the member's chosen alternative plan.

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52 See Financial Services Authority (1998, 1999) and Whitehouse (2000*c*).

53 The employer proportion of the contracted out rebate of social security contributions is diverted to the personal pension plan automatically.

54 National Association of Pension Funds (2000) and Government Actuary (2001). Note also that many employers also withdraw non-pension benefits from employees opting out of their occupational pension scheme: for example, just 38% of plans will give life insurance benefits to non-joiners.

55 This has been proposed as a solution to the problems related to mis-selling in the United Kingdom by the Office of Fair Trading (1997) and the Institute for Fiscal Studies (Dilnot et al., 1994).

56 Again, this option has been proposed in the United Kingdom. The government, however, withdrew the proposal for such as strict opting out test contained in Department of Social Security (1998). Instead, the government will rely on public information (including pension 'decision trees' — see Whitehouse, 2000*c*) and on stricter regulation of personal pension marketing and sales through the new Financial Services Authority.

3.3 A way forward for Switzerland

115. Managers of occupational pension plans in Switzerland are, probably unsurprisingly, not in favour of member choice of investment manager. Such a reform would remove what amounts to their monopoly over pension provision for their employees.

116. The Federal Office of Social Insurance commissioned PRASA, an independent consultancy specialising in pensions, to investigate the issue of free choice of pension fund. This was published as Federal Office of Social Insurance (2000). The report is based on detailed interviews with around 50 managers of occupational schemes, covering some 400 000 members, and on meetings of working groups of the Swiss Association of Pension Institutions, which brought together some 600 people.

117. The report considered a specific model. Individuals would have free choice of pension funds while the latter would have the obligation to affiliate any person choosing that fund. As currently, the contribution rate to the pension fund would be agreed by employers and employee representatives. It would also be subject to the same minimum benefit conditions as presently and the rule that employers must make at least half the contributions. Members would be free to change pension funds on the same conditions as specified in the 1995 law on portability.

118. Pension fund managers thought a reform along these lines would undermine the interaction between employers and employees over the issue of pension provision: retirement incomes would become the exclusive concern of employees. They were also concerned that systemic change might undermine their ability to use the pension system in corporate restructuring. Indeed, many argued that the occupational pension scheme was a central part of their human resources policy. While pension fund managers accepted that competition and the dynamism of the market would be increased, they were sceptical that this would translate into useful or attractive options for members.

119. These objections are in large part valid, but the model that managers were asked to consider is an extreme one. It would essentially involve the dismantling of the current structure of occupational pensions and their replacement with a choice of personal pension providers, along the lines of the reforms in Latin America and Eastern Europe. However, member choice of provider, with opting out rules along the lines of those set out in the previous section, would be compatible with the continuation of the current regime in its current form.

120. The ability to contract out of an occupational pension plan in the United Kingdom has not led to a significant decline in coverage of occupational plans. For example, since 1985, the proportion of full-time women not joining their employers' pension scheme has risen from 21 to 29%, and of men from 12 to 20%.[57] This experience implies that, with the correct safeguards, the proportion of members opting for choice of pension manager would not be large enough to dismantle the current occupational pension regime. However, free choice of pension manager would be an important competitive spur for lagging occupational pension plans to improve their terms. It could prove an attractive option for some groups of employees – for example, younger and more mobile workers – and would allow compulsory coverage to be expanded to groups not covered by the current system, particularly short-term workers.

57 It is not possible to exclude those who are ineligible to join the scheme (for example, because they are too young, too old or because their tenure is too short) from these figures. The totals therefore do not wholly represent people *choosing* not to join their employer plan. *Source*: *General Household Survey*, various years. Furthermore, this, to a large extent, reflects people maximising their current income (by reducing the pension contributions they have to make). Around 45% of employees not joining their employer plan take out a personal pension, while the rest default to the public plan, Serps.

4. Member choice in pensions: withdrawal options

121. This section explores a number of issues in pension withdrawal. It begins with a review of current practice and then looks in detail at the issue of annuitisation.

4.1 Benefit pay-outs in Switzerland

122. The benefits that members of occupational pensions in Switzerland receive depend on the design of the individual plan, although they are subject to a broad set of rules. These specify the ages at which the pension may be drawn, the annuity rate to be used at conversion and the circumstances under which lump-sum withdrawals are permitted. The last include becoming self-employed, permanently leaving Switzerland, house purchase (see section 4.1.1) and if the accumulated balance is small. Schemes have to accept a request for a lump-sum withdrawal made three years before retirement. However, in practice, most plans let people opt at retirement.

123. Aggregate benefit payments, shown in Table 14, increased from 1.5% of GDP in 1970 to 4.9% of GDP in 2000. The average occupational pension in payment in 2000 was around SFr 28 000 (equivalent to around 46% of economy-wide average earnings[58]) and the average lump sum payment was SFr 125 500. The balance of pay-outs has changed over time. Lump sums made up around 19% of the total in the late 1990s and 2000 compared with just 12% in 1980.

Table 14. Occupational-pension pay-outs, 1970-2000

	Pensions (SFr billion)	Lump sums (SFr billion)	Total (SFr billion)	Total (% GDP)
1970	1.2	0.2	1.3	1.5
1978	2.6	0.4	3.0	2.0
1980	3.0	0.5	3.4	1.9
1987	5.5	1.0	6.5	2.5
1990	7.3	1.5	8.7	2.8
1992	9.0	1.8	10.8	3.2
1994	10.7	2.3	13.0	3.6
1995	11.6	2.6	14.1	3.9
1996	12.5	2.8	15.4	4.2
1997	13.2	3.0	16.2	4.4
2000	16.3	3.9	20.2	4.9

Note: columns may not sum to total due to rounding
Source: Pension Fund Statistics, Federal Office of Statistics, Federal Office of Social Insurance

4.1.1 Withdrawals for housing

124. Accumulated pension assets can be used in a variety of ways to finance housing. These including buying or improving a home, participating in housing co-operatives or repaying mortgage principal. However, pension assets cannot be used to pay for maintenance or mortgage interest.

58 The earnings figure relates to the average earnings of a production worker. See OECD (2002).

125. Pension scheme members can either withdraw or pledge any amount between SFr 20 000 and the full transfer value of their account once every five years.[59] From age 50, it is possible to withdraw the higher of the accumulated fund at age 50 or half of the current value, which is designed to maintain at least some of the accumulated fund for paying retirement benefits. Withdrawals and pledged capital are taxed by the cantons as a notional annuity. Withdrawals have to be repaid to the pension fund if the purchased housing is sold or rented.

126. Switzerland has a relatively low rate of owner-occupation – 31% – compared with 54% in France, 63% in the United Kingdom and 64% in the United States. The tax system, unlike many other OECD countries, does not give preferential treatment to owner occupied housing and there are taxes on capital gains, property sales and on imputed income from owner-occupation.[60]

127. The provisions for withdrawal of pension assets for housing were liberalised in 1995. However, the new rules are not expected to have a major impact on home ownership. Younger participants, for example, can only withdraw small amounts. For example, a 40-year-old man with 16 years' contributions on average earnings of SFr 60 000 would be entitled to withdraw SFr 64 650.[61] He would be able to buy a house worth SFr 350 000 on standard mortgage guidelines.

128. Many analysts are sceptical of the value of mixing housing and retirement-income finance in one instrument.[62] Nevertheless, owning a home without a mortgage undoubtedly improves living standards in retirement, compared, for example, with people who need to pay rent. However, this can lead to the problem of 'asset-rich, income-poor' pensioners, often with high costs of maintenance.[63]

129. Given the low take-up of the housing withdrawal scheme in Switzerland, much of this debate is moot. The main concern appears to be the administrative burden of running this complex scheme.

4.2 International experience

130. The issue of the mode of withdrawal of pension assets has become controversial in a number of OECD countries. In Australia, for example, the vast majority of pension benefits continue to be received as a lump sum on retirement. Policy makers have repeatedly adjusted incentives to encourage retirees to take out an annuity or some other product that produces an income stream.[64]

131. Across OECD countries, the decline in long-term interest rates has led to a large fall in annuity rates. This in turn has led to pressure to relax the rules that require the benefits of pension schemes to be delivered as an annuity.[65] In the United Kingdom, there has been a series of policy changes liberalising

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59 Transfer values are calculated according to prescribed rules: see Queisser and Vittas (2000), section 3.9.

60 See OECD (1994*a*,*b*).

61 Queisser and Vittas (2000), section 3.10.

62 See, for example, OECD (2001). This is a particular problem in Singapore, where Central Provident Fund balances are usually used to buy owner-occupied homes leaving little for retirement incomes: see Asher (1999).

63 See the extensive discussion in Disney and Whitehouse (2001).

64 See Bateman and Piggott (2001) and Doyle and Piggott (2001).

65 See, for example, McDonald (1999) and McCarthy (2000) on the United Kingdom.

annuitisation requirements. In particular, people are now able to make ‘scheduled withdrawals’ from their pension account without turning into an annuity, a process also known as ‘draw down’. The amount of the scheduled withdrawals must lie within prescribed limits, which are designed to ensure that older people do not exhaust their pension savings. The residual in the account must be annuitised at age 75.

132. There are two main economic arguments to justify mandatory provision for income in old age:

- Paternalism: people are myopic, and left to their own devices will not save enough. Others may be forward looking, but may lack the information needed to make sensible savings choices; and

- Moral hazard: people will not save enough if they expect government to rescue them in their old age. Moreover, governments cannot credibly commit to leave pensioners destitute.

133. These same arguments apply to withdrawals in retirement-savings systems. Myopic people might spend their savings early in retirement. In addition, public safety nets encourage even the forward looking to spend to use up their wealth and then rely on government support. Lack of information – on inflation or life expectancy, for example – can also mean that people make choices they later regret.[66]

134. Table 15 shows governments’ responses to these arguments. The most interesting policies are those of the Latin American countries, which tend to allow flexibility of withdrawal of pension benefits once a minimum annuity income and/or replacement rate has been reached. Such a policy seems sensible: it avoids moral hazard by ensuring that all older people with sufficient pension balances have an income above the safety-net level. This minimum retirement income proposal has also been made in the United Kingdom (McCarthy, 2000). Above the minimum annuity, people might be able to withdraw pension assets as a lump sum or follow a path of scheduled withdrawals.

66 Naturally, these arguments have less force in a voluntary retirement-savings scheme. People are unlikely to be sufficiently forward-looking to save for a pension and then suddenly become feckless in their retirement.

Table 15. Withdrawal restrictions in mandatory pension systems

Country	Rules
OECD countries	
Australia	Minimum pensionable age of 55
Hungary	Minimum pensionable age increasing gradually to 62 by 2009
Poland	Minimum pensionable age of 65 (men), 60 (women)
United Kingdom	Minimum pensionable age of 65 (men), 60 (women); annuitisation can be delayed until 75 with draw down until that age
Non-OECD countries	
Argentina	Minimum pensionable age of 65 (men), 60 (women)
Bolivia	Minimum annuity of 70% of minimum wage
Chile	Minimum annuity of 110% of minimum wage; minimum replacement rate of 50%
Colombia	Minimum annuity of 110% of minimum wage; minimum replacement rate of 70%
El Salvador	Minimum annuity of 160% of minimum wage; minimum replacement rate of 70%
Mexico	Minimum pensionable age of 65
Peru	Minimum annuity of 110% of minimum wage; minimum replacement rate of 50%

Source: OECD (2001), Disney and Whitehouse (1999), Doyle and Piggott (2001)

135. The second argument in favour of flexibility draws on the same analysis as the issue of portfolio choice examined in section 2. Annuitisation is equivalent to a one-off shift in asset holdings from a balanced portfolio before retirement to one consisting purely of bonds when the pension is withdrawn. (This is because bond investment typically back insurers' annuity liabilities and annuity rates track changes in the interest rates on long bonds.) However, given the long periods people now spend in their retirement, it is unlikely to be optimal to hold a portfolio wholly in bonds at age 60 or 65. Indeed, Kapur and Orszag (1999) show that, under reasonable assumptions of people's preferences over risk, the optimal portfolio even at age 70 would be invested 30% in equities. Also, Milevsky (1998) shows that it is optimal for retirees to defer annuitisation until quite advanced ages. For example, a 65 year old woman would have a 90% chance of getting a better return by investing in a broad portfolio and then converting remaining wealth to an annuity at 80. For a man, the probability would be 85%. We argued in section 2 that people differ in their circumstances and their attitudes to risk. There are thus benefits to offering people choice in the withdrawal stage as well as the accumulation stage of the pension system. This can be achieved either through a system of scheduled withdrawals or through 'variable' or 'participating' annuities whose value varies with the performance of the underlying investments.[67]

136. Finally, the income stream resulting from an annuity is inflexible because people's spending needs might vary during retirement. A 'stereotypical' pattern of consumption needs during retirement might, for example, be U-shaped. Early in retirement, people are keen and able to follow expensive leisure pursuits (holidays etc.). Later on, limited infirmity limits older people's activities and so their spending.

67 See Valdés-Prieto (1998).

Finally, a period of long-term care might be required. Annuitisation produces a constant income stream. This argument has been over-stated. For example, many pensioners are able to dis-save early in their retirement by running down other, non-annuitised assets. Later on, they can save to build up assets to cover the costs of long-term care. Furthermore, financial innovation is likely to lead to products that combine long-term care insurance with an annuity.[68]

4.3 A way forward for Switzerland

137. Public policy objectives for occupational pensions could be achieved while introducing greater flexibility in pension withdrawal options. An attractive proposal would be specify a minimum retirement income, which could be specified either as an absolute standard or as a minimum replacement rate (or both). People would be required to buy an indexed annuity with provision for survivors' benefits to achieve this minimum standard. Above that level, people would be able to buy different types of annuity: these would differ in terms of indexation and survivors' provision and include variable or participating annuities where the value of the benefit varies with the performance of a broadly invested portfolio.

138. An alternative would be to allow scheduled withdrawals against an actuarially-determined formula. Again, the funds would remain broadly invested. It might even be sensible to allow lump-sum withdrawals up to a limit (say, one quarter of the accumulated balance, provided that the minimum retirement income had been achieved). The rules for choice of retirement age are currently flexible, but people who defer their retirement are penalised because the pension increment for later retirement is less than the actuarially-neutral level. It would be sensible to use the opportunity presented by the review of the minimum annuity conversion factor to adjust the increment rate. In the medium term, a move toward market provision of annuities would have two main advantages. It would ensure that annuity rates would reflect expected changes in longevity and continue to reflect the variation in the cost of pension provision with the age at which it is drawn.

5. Conclusions

139. The issue of choice in the Swiss pension system is looming larger in the domestic debate. A report for the Federal Office of Social Insurance (1999, p.2) observes:

> 'La question d'individualiser la prévoyance professionelle se pose de plus en plus. On observe également que les milieux politiques exercent une pression toujours plus marquée pour que la prévoyance professionelle évolue dans cette direction.'

140. We have argued that choice is important in social protection in general and in pensions in particular because people differ in their circumstances and their preferences. Choices in the Swiss occupational pension sector are currently curtailed. Yet, we have shown that there is considerable scope for increasing member choice without, as some Swiss commentators have feared, dismantling the current system of occupational provision of pensions.[69]

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68 See Warshawsky, Spillman and Murtaugh (2001).

69 For example, Federal Office of Social Insurance (2000) and Allenspach (2001).

141. We have drawn on the available sources of data on Swiss pension funds. However, these have very limited information on the rules of pension plans. In other countries with large occupational-pension sectors, such data are collected regularly[70].

142. The availability of such data allows for much more thorough analysis of the occupational pension sector than is currently possible in Switzerland. They are also very useful for employers to measure how their scheme compares with other employers' plans even, for example, within the same sector or region. Similarly, they are useful for members and employee representatives in negotiations about plan provisions. It would be highly desirable for improved data on the Swiss occupational pension sector to be collected and published along these lines.

143. Returning to the issue of choice, we explored three areas in which members' options might be expanded. We drew heavily on the experience of other OECD countries that have offered member choice of one form or another, particularly Australia, the United Kingdom and the United States. Their experience offers valuable lessons for Switzerland.

144. The section on member choice of <u>portfolio</u> proposed two ways forward. In the first, funds would be permitted to offer member choice. This would necessitate some legal and regulatory changes and effective supervision. In the second, funds would be required to offer different investment options. Subject to a series of safeguards, we believe that either of these policies could significantly improve members' welfare without compromising the existing system.

145. Member choice of <u>pension fund manager</u> could have a more profound effect on the occupational pension sector. Nevertheless, choice of fund manager has been introduced in the United Kingdom without substantially undermining occupational pension schemes. Competition for managing members' pension assets could significantly increase levels of service compared with the current system: only poorly managed funds should have anything to fear. Again, we set out a series of safeguards that would be needed to avoid problems of 'mis-selling'.

146. Finally, member choice of <u>withdrawal</u> is again currently limited. We proposed that members should have access to at least some of their pension assets at retirement, which they could perhaps withdraw as a lump-sum or could invest in a draw-down scheme or a participating annuity. In either of these schemes, members that are more risk-tolerant could invest their funds more broadly and enjoy the additional return.

147. All of these reforms would, of course, need careful attention to the detail of their design and implementation. Nonetheless, the benefits to individuals deriving from the ability to tailor their retirement savings better to their wants and needs would be large.

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70 In the United Kingdom, the Government Actuary's department (2001) surveys occupational schemes every four years, although the results are published with a very long delay.70 The National Association of Pension Funds carries out an annual survey of its members. Although more up-to-date, this survey is not representative of the occupational pension sector as a whole because it concentrates on larger plans;

In the United States, the Department of Labor carries out an annual survey of pension plan provisions (see Mitchell and Dykes, 2000, for an analysis);

Canada also surveys occupational plans regularly. One such survey underlies the analysis in OECD (1995).

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