

Setting the rate

Fixing the following year's minimum return for pension funds is an annual task for the Swiss government. **Nathalie Munaretto** and **Ljudmila Bertschi** look at current factors

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Swiss occupational pension provision was made compulsory in 1985, contributing to a spectacular accumulation of second pillar assets. According to the Watson Wyatt 2008 Global Assets Study, at the end of 2007 pension assets in the second pillar in Switzerland amounted to CHF676bn (€408bn), representing some 150% of GDP, the highest percentage value in the world and the third highest absolute amount in Europe after the UK and the Netherlands.

In the second pillar, the savings process is accompanied by death and disability benefits including survivor and disability pensions and capital payments, which are offered by both pension funds and insurance companies.

The majority of occupational plans provide more generous benefits than the minimum level required under the law, the BVG. The BVG requires minimum benefits in the form of minimum age-related savings credits, a minimum interest rate on accumulated credits and a minimum annuity conversion factor. Due to the minimum interest rate guarantee (the so-called BVG minimum interest rate) Swiss defined contribution saving plans are cash balance plans by nature. Each pension plan has to ensure that the mandatory minimum level of benefits is maintained.

Initially, the BVG-minimum interest rate was often applied to the whole savings account even if it was much higher than the mandatory level. Following the first BVG revision in 2004-2006 the minimum interest rate needs to be credited only to the mandatory portion of the savings account. Depending on the provisions of the benefit plan (insured salary, saving contributions, guaranteed interest rate) the mandatory portion of the savings capital makes up around 20-50% of total saving capital in autonomous pension funds. In insured multi-employer plans the mandatory benefits make up about 80% of savings.

The pension fund board is free to decide whether the mandatory guarantees should be applied to the whole account or to only the mandatory part. Many pension funds make use of this legal stipulation and decide if any additional credits will be granted to individual accounts each year based on the financial situation of the plan. There are still 'good employers' who guarantee interest rates in their pension plan rules of 4-4.5% or who guarantee to use the BVG minimum interest rate plus an inflation expectation. However, such plans are in a minority.

According to the law, the minimum interest rate should be based on yield trends for marketable investments, especially government bonds, as well as rates of return on stocks and shares, bonds and real estate. The Federal BVG Commission is responsible for preparing a basis for decision making for the Federal Council, the cabinet. The currently 19-member

commission consists of representatives of many interest groups, including trade unions, pension funds, insurers, employers' associations and economists. Each May the commission proposes a preliminary rate and Federal Council settles on the final level for the next year in September.

For the 18 years to 2003, the minimum interest rate was 4%. In 2003, in the wake of the bad performance of Swiss capital markets in 2001-2002, it was reduced to 3.25% and then to 2.25% in 2004. For 2008 the BVG minimum interest rate is 2.75%.

Since 2003 it has been determined very conservatively due to the high volatility of capital markets. Trade unions consistently argue for a higher minimum interest rate than the other social partners. The Swiss insurance association has suggested introducing a variable, market-related (mark-to-market) BVG-minimum interest rate based on a transparent, comprehensible formula like 70% of a rolling seven-year moving average of government bonds of seven year duration ('70-7-7'). Based on this formula the BVG minimum interest rate for 2009 should be 1.75% as the yield on seven-year government bonds is currently 2.9%.

Trade unions reject this approach and have demanded 2.5% for 2009 to secure better saving benefits for employees with occupational provisions with insurance companies. Company pension funds are less affected by this formula as employees and pensioners insured in the fund will sooner or later receive the surplus as extra credits to their accounts, or pension increases.

Were the 70-7-7 approach to be applied on regular basis it would require changes to Swiss pension legislation.

Undoubtedly the minimum interest rate is a political issue and reflects the expectations of different interest groups like the trade unions and insurance companies, which are difficult to balance.

Since 2005 the issue of defining a consistent formula for the minimum interest rate has been discussed in Switzerland more intensively than before. Insurance companies have used a new system of bonus sharing introduced in the first BVG revision and prefer to give a low level of guaranteed interest rate and distribute extra profits via a bonus-sharing mechanism.

The announcement of the 2009 rate has been delayed due to market conditions and is not expected until later this month. Nevertheless, expectations are that it will be lower due to the bad performance of the financial markets so far this year.

Investment returns in Switzerland have historically been low as there are legal restrictions on investments in equities and property, and as most pension funds have to maintain their funding level from their own resources. There are some exceptions to this, mostly among pension funds of US multinationals. Those pension funds

can pursue a more aggressive asset strategy because of an employer guarantee to meet the balance of costs.

On average the typical asset allocation of a Swiss pension fund consists of about 33% equities, 38% bonds and 29% in other assets like real estate and alternative investments. UK pension funds have about 64% in equities and 24% in bonds. About half of Swiss equity investments are invested in domestic equities. On average the annual growth rate of pension assets for the last 10 years was 4.7% in Switzerland compared with 7.4% worldwide. During 2007 the growth was -1.9% in Switzerland compared to 2% worldwide.

Switzerland has one of the lowest inflation levels in Europe and a very stable economy. The long-term rate of inflation in Switzerland used for actuarial valuations under IFRS is around 1.5-2%. About a year ago the inflation rate was nearly zero, but now the situation has changed and the current level of inflation is 3.1%. This high inflation is a considerable worry.

Some benefits are linked to the inflation rate by law. The mandatory level of survivor and disability pensions according to the BVG has to be indexed according to the cost of living as in the first pillar. This mandatory level always has to be compared to the current level of pensions. However, retirement pensions are not legally required to be indexed, but are generally increased on an ad hoc basis depending on the financial position of the pension fund.

Only a few pension funds stipulate the indexation of the retirement pensions in their plan rules – among them are some pension funds of the public sector and some big corporate pension funds of multinationals. Indeed the trend in the Swiss market is not to promise any indexation. This is due to the requirement to value employer benefits based on international accounting standards (IFRS or US GAAP) for listed firms and also due to new local accounting standards (Swiss GAA/ FER 26) in the Swiss pension legislation.

Therefore, most active members and pensioners will probably suffer from increasing inflation. Any additional interests granted to old-age savings accounts of active members following a better asset performance than the BVG minimum interest rate are restricted by some legal requirements to fully fund additional actuarial and investment fluctuation reserves or at least fund them to a certain level.

Pension payouts are generally no longer indexed on a regular basis but are increased by one-off payments depending on the financial position of the fund. Higher inflation also affects first pillar pensions, which are indexed regularly based on a combination of wage and price inflation. Due to the fact that first pillar pensions are used as a co-ordination deduction to calculate the insured salary for the second pillar, the purchasing strength of future second pillar pensions will be lower as a result of increasing inflation and the target level of retirement benefits may not be reached in cash balance plans.

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