Regulating supplementary pension funds. The social dimension.

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Four problems related to the social policy function of occupational pensions

- How to generalise coverage?
- How to guarantee a given level of coverage?
- How to convert capital into an annuity?
- How to secure the compensation of inflation?

How to generalise coverage?

- Few countries have managed to develop extensive coverage of supplementary pensions
- Australia, Switzerland: mandatory by law
- Netherlands, Denmark: through collective bargaining
- In the UK: several failed attempts. In the 2000s employers support higher state pensions rather than compulsory occup. coverage

Generalised coverage in Switzerland

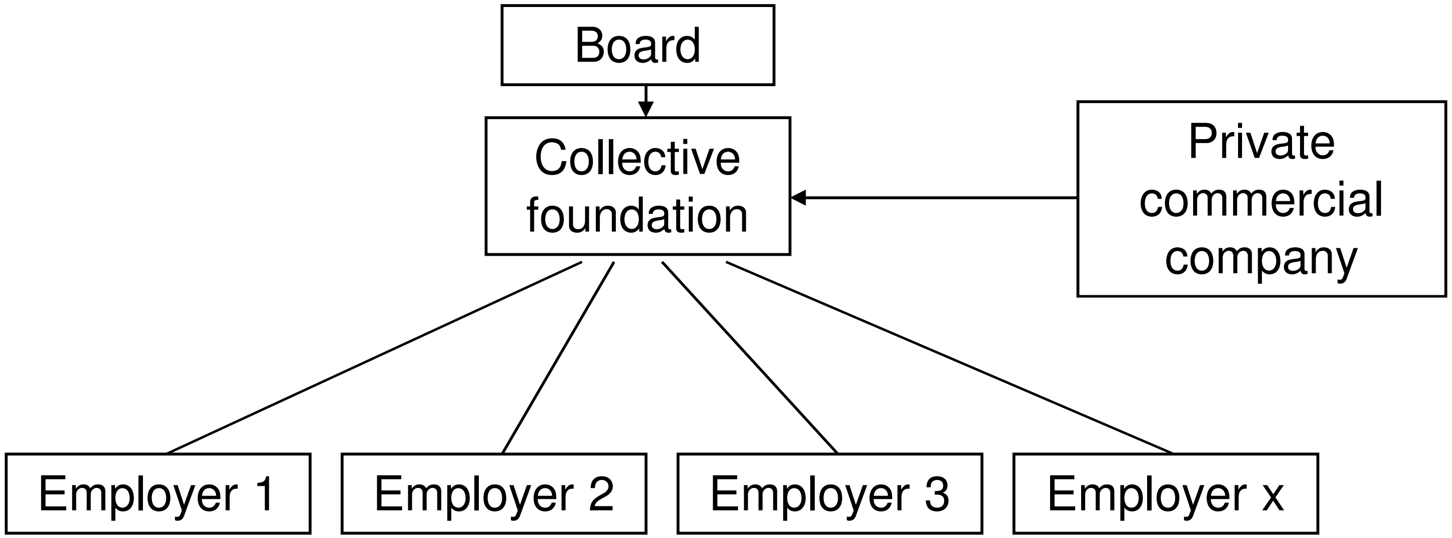
- Politically: compulsory coverage was proposed by right-of-centre parties in response to a more statist proposal. In force since 1985.
- Legally: employers are required to insure their employees whose:
  - Earnings exceed approx. 32% of the median wage, and
  - Are employed for at least three months

Different solutions exist for employers

- Own pension fund (for large employers) (6% of insured employees)
- Joint funds (branch funds) (20%)
- Collective foundations (mostly set up by a bank or an insurance company) (35%)
- Other multi-employer funds (holdings, consortia, public sector funds) (39%)

➔ theoretically: all these institutions must be managed according to parity representation (employers/employees)

Parity representation? Problematic in “Collective foundations”



Governance problems in collective foundations

- Little involvement of the stakeholders, especially employees
- During the 1990s, suspicion of a “Rentenklau” (pension theft)
- Adoption of more transparent accounting rules in 2004, and better involvement of employees in governance structures.

How to guarantee a given level of coverage?

- Defined benefit schemes (NL)
- Minimum legal requirements in DC schemes
  - Contributions
  - Interest rates

The legal minimum in the Swiss 2nd pillar

- Pension funds are relatively free in terms of benefits, but have to provide a minimum level of coverage.
- The minimum is based on three parameters:
  - Notional contribution rates, age related and applied to a portion of the salary
  - A minimum interest rate
  - A "conversion (or annuity) rate" (capital ➔ annuity)

Notional contribution rates

Age	Taux
25-34	7%
35-44	10%
45-54	15%
55-64	18%

Fixing of the minimum interest rate

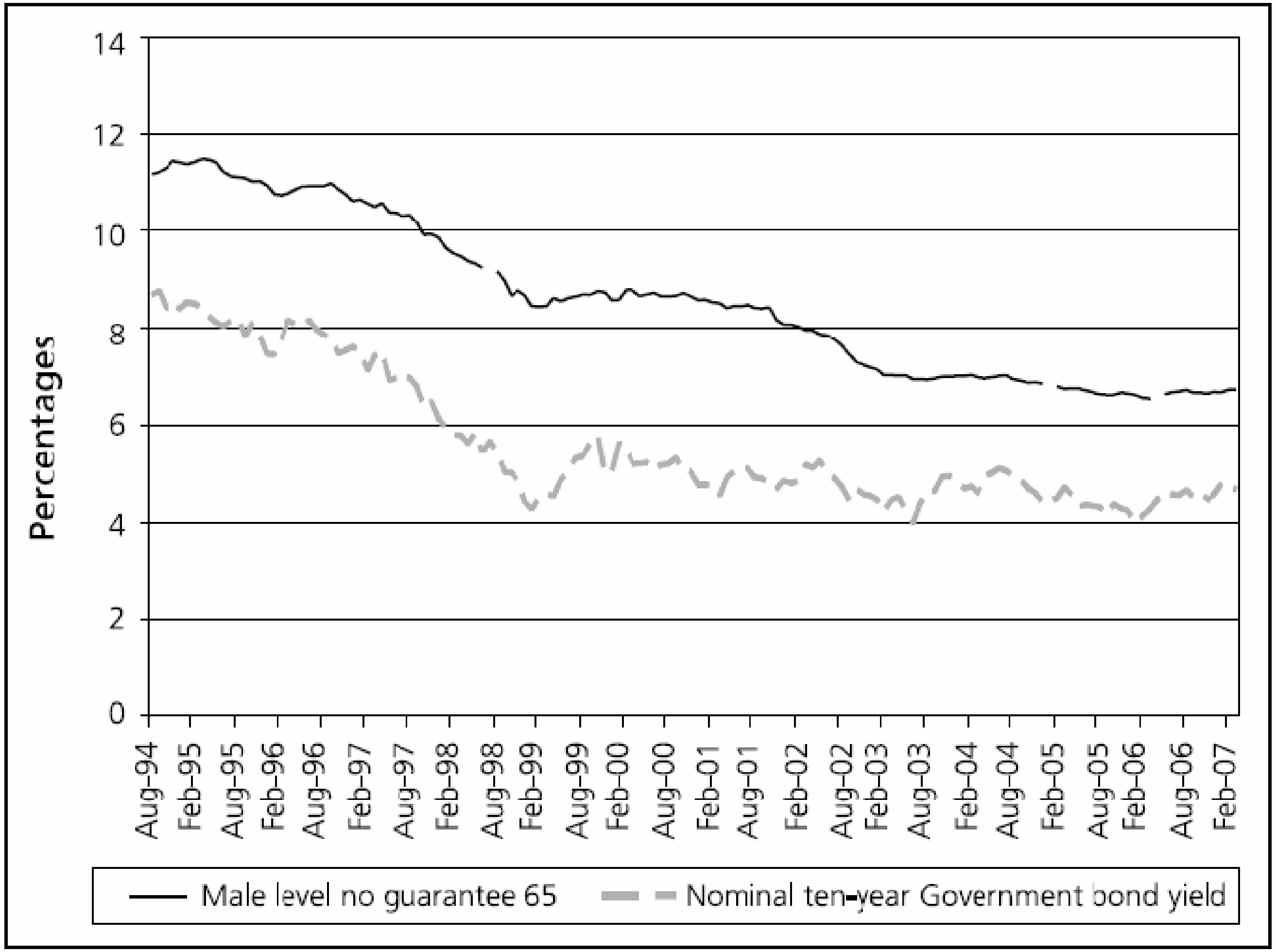
Year	Interest rate
1985-2002	4%
2003	3.25%
2004	2.25%
2005-2007	2.5%
2008	2.75%
2009	2%

- Rate is decided every year by the government
- Highly politicised exercise
- Towards an automatic mechanism?
- A more stable rate?

How to convert capital into an annuity?

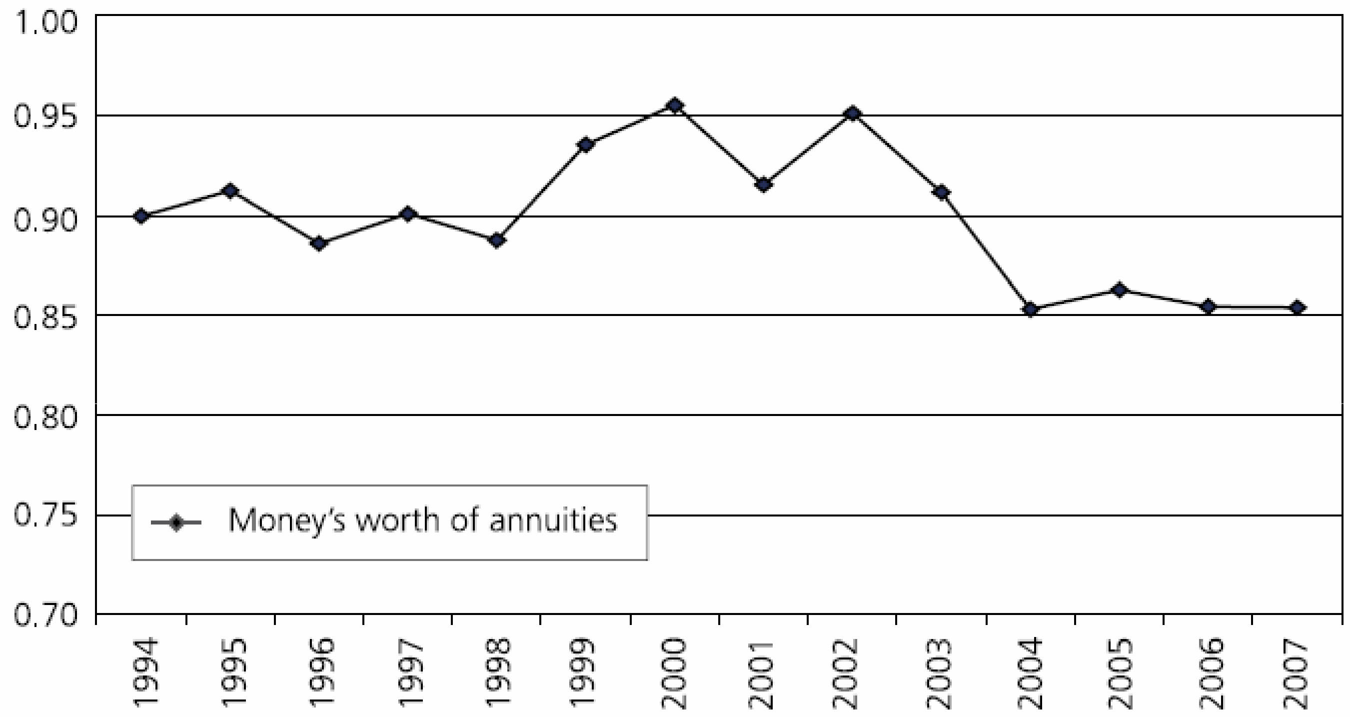
- Purchase of annuities on the market
- Rate depends on life expectancy and interest rates
- Market segmentation (gender, smokers, health status)
- Large fluctuations over time
- In the UK: decline in annuity rates over the last two decades
- In the UK: widening gap between the price of annuities and their fair value

Figure 5.3 Comparison of annuity rates with bond yields



Source: Cannon, E. and Tonks, I. (2007) Money'worth of pensions annuities, London DWP Research Report 563.

Figure 6.2 Money's worth for male, 65, level annuity, using combined 'lives' mortality



Figures plots the summary money's worth values from the first column of Table 6.1, using the appropriate life expectancy figures for the relevant years.

Source: Cannon, E. and Tonks, I. (2007) *Money s' worth of pensions annuities,* London DWP Research Report 563.

Fixing of the conversion rate by law

- More stable system
- No market segmentation. More regressive?
- Risk: deviation from actuarial fairness
  - If rate is too high: shift to a partly PAYG system
  - If rate is too low: preference for capital over annuity

Fixing the conversion rate in Switzerland

- In 1985, the conversion rate was fixed at 7.2%
- It is currently being lowered to 6.8% (until 2013)
- Under pressure from the insurance industry, the government has proposed a further lowering to 6.4%
- Popular vote will take place in March 2010

How to secure the compensation of inflation?

- Inflation may not be a pressing problem, but even low rates can eat away considerable purchasing power over long periods in retirement
- Over 15 years, 2% inflation means a reduction of 24% in the real value of the benefit
- Inflation proofing can be bought, but is very expensive.
- For example, in the UK, the starting rate for an inflation-proof annuity can be 28% lower (man aged 60).

Inflation-proofing in the Swiss system

- According to the law, pension benefits must indexed to inflation, as long s the financial situation of the funds allows it.
- Decision is taken by the (parity) governing body
- In original proposal (early 1980s), the government planned the introduction of an additional contribution, meant to provide inflation proofing on a pay-as-you-go basis.
- Parliament removed this element

Inflation proofing among Swiss pension funds, % of funds applying (1996)

	Full inflation proofing	Partial/occasional	None or no information
Public sector	28	38	34
Private sector	17	42	41

Source: Conseil Fédéral (2000) *Message sur la 1ere révision de la LPP*, Berne.

Conclusion

- Most issues can be settled through the market or through legislation
- Often, with different distributional consequences
- Market solution tend to require more knowledge
- Several challenges:
  - - maximise social policy objectives while remaining attractive for non-state actors
  - - maximise fairness and choice without becoming unstable and user-unfriendly