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A tale of two pension fund industries: comparative perspectives from Switzerland

To everyone who has ever walked the strenuous "Dutch Mountain Trail" in Zuid-Limburg with its glorious Seven Summits it is obvious, that the Netherlands and Switzerland entail striking similarities. In fact, both have a 3-pillar pension system with a state pension as the first pillar, a second pillar consisting of pension funds accruing employee and employer contributions, and lastly as a third pillar voluntary individual income provision.

While the Dutch pension system is going through a monumental shift, it can be useful to take a step back and compare notes on challenges and solutions in a similar market, namely the Swiss occupational pension fund market. This market is exploring risk management strategies that may be relevant to the Netherlands as it transitions from a defined benefit to a defined contribution fund industry.

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THE SWISS TAKE ON DEFINED CONTRIBUTION VS. DEFINED BENEFIT

Switzerland currently has around 1300 private sector pension funds, including approximately 100 collective foundations. A collective foundation is a legally independent institution that companies can affiliate with to provide occupational pensions for their employees and to leverage economies of scale when it comes to investment strategies or fixed costs. A collective foundation has many similarities to the Algemeen Pensioenfonds (APF) introduced in the Netherlands in mid-2016.

According to Swiss law (BVG), each pension fund and collective foundation must always be able to fulfil their obligations to their members. This promise is measured by the coverage ratio: the percentage ratio between the available pension capital and the required pension capital. In 2022, the latest available full-year financial figures, the average coverage ratio across private pension funds in Switzerland was approximately 110%.

So, does Switzerland have a defined benefit or rather a defined contribution pension fund industry?

Switzerland knows a hybrid between the two. Like in a defined contribution scheme, insured members bear the financial market risk. But the exposure to financial market risks is floored. The BVG requires capital to be credited a minimum guaranteed interest rate. This interest rate is 1.25% as of 1 January 2024. The cushion to the downside risk comes with a cap on the upside performance which is used to fund a volatility reserve.

Next: In a defined benefit system, the pension fund guarantees a certain notional annuity payment, creating a significant liability for the pension fund. In Switzerland, pension funds also offer a guarantee stemming from the minimum conversion rate. The conversion rate is a fixed percentage specified in the BVG, currently set at 6.8%. In simple terms, a hypothetical retirement capital of EUR 100'000 at a rate of 6.8% translates into a guaranteed annual pension of EUR 6,800 for the insured member. Unlike the Dutch market, the Swiss pension fund is not allowed to go below the minimum conversion rate or reduce the annual pension payment once retirement has commenced.

As such, although Switzerland has a defined contribution system, meaningful parts of the financial market risk (minimum interest rate during the accumulation phase) and the annuitisation risk (guaranteed conversion rate) remain with the pension fund.

REINSURANCE: THE NEXT FRONTIER IN THE PENSION FUND INDUSTRY: SHARING PERSPECTIVES FROM SWITZERLAND

The challenges faced by the pension (fund) industry are neither becoming fewer nor less complex. Examples include interest rate and equity market volatility, inflation, geopolitical risks, demographic changes, peak events such as the pandemic, and ESG considerations. These factors require constant re-adjustment of the investment strategies, the hedging measures, and the technical assumptions on model inputs such as mortality or disability risks.

Ultimately, however, the main risks for pension funds boil down to financial market risks (mostly in the accumulation phase) and longevity risks (in the payout phase). The existing de-risking toolkit spans two extremes from full risk transfer through pension buy-outs to full risk retention by the pension funds. As trustees seek solutions to steer a course through rough waters, we observe an increased dialogue between the Swiss pension funds, advisors, and more recently also reinsurers, to explore the various shades of grey between these two extremes. Two such potential solutions are gaining traction in the Swiss market. They are generating interest and appreciation among pension fund decision-makers, and concrete use cases are currently underway.

Firstly, an obvious choice are longevity swaps which transfer the longevity risk (the risk of members living longer than expected) to an insurer or reinsurer. According to the Dutch National Statistics Bureau, life expectancy at the age of 65 has increased from 17.4 years in 2000 to 19.7 years in 2022 and is expected to grow continuously to 20.9 years by 2030. Or put differently, the population aged from an average of 82 years to 86 years in a matter of 2 decades. Already a well-established risk transfer solution, particularly in the Netherlands, longevity swaps are usually deployed by insurers rather than by pension funds. More recently there has been growing interest from pension funds in Switzerland in hedging their longevity exposure through longevity swaps. This is especially helpful for pension funds with a high proportion of pensioners, as the volatility of future mortality poses a key risk to the financial strength of the pension fund. In these circumstances, longevity swaps are seen as part of an integrated risk management system rather than as a means of seeking capital or solvency relief.

In contrast to a buy-out, the assets in a longevity swap structure remain with the pension fund and may be invested in higher-yielding assets due to the greater predictability of the size and timing of future cash outflows. Waiving the transfer of asset stabilises the financial planning, eliminates the day-one liquidity strain and minimises the credit risk to the reinsurer. This is why many regulators favour swaps over so-called funded longevity reinsurance, in which future liabilities are sold for a single upfront payment.

Longevity swaps focus on the liability side of the pension funds' balance sheet. A second potential solution aims to help pension funds to de-risk both the asset and the liability sides of their balance sheet. Such solutions, known as coverage ratio stabilisation structures, could provide effective protection against adverse financial results on a pension fund's asset book (for example protecting the bond or equity portfolio) in conjunction with longevity de-risking. With this structure, the pension fund can determine the desired level of downside protection. The fund defines the value it wishes to have guaranteed as well as the term of the contract, which can be on an annual or multi-year basis. Although two distinct set of risks are covered under this solution – financial market and longevity risks – the pension fund benefits from having a single one-stop shop by facing only one counterparty, namely the reinsurer.

The flexibility of the coverage stabilisation solution could allow pension funds to limit either short-term strategic volatility, e.g., when transitioning the accrued pensions from the current system (Defined Benefit) to the new Defined Contribution system ("invaren") or to hedge against tail risks in the mid- to long-term. In the Swiss market, such a stabilisation structure has been tested with several industry experts and is primarily positioned for the passive (retiree) population of pension fund portfolios.

Navigating the uncharted waters of financial market volatility and uncertain mortality trends will require more and innovative solutions to turn challenges into opportunities. Pension funds in the Netherlands can reimagine resilience by leveraging a wider risk management toolkit, which may involve fostering new partnerships with reinsurers. ■