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## III. A Comparison of the Swiss, Dutch, and U.K. Pension Systems, with Emphasis on the Occupational Pension Pillars[43]

### A. Introduction

91. **Pension systems in many countries have been affected by the challenges posed by aging, persistent low interest rates, and the sharp decline in equity values in 2000–02.** Switzerland has implemented some reforms to address these challenges, but additional ones are needed. The public sector pillar of the pension system is generating increasing pressures on the overall government balance. At the same time, the occupational pension pillar has some economic, regulatory, and supervisory risks and weaknesses.

92. **To offer a cross-country perspective, this note provides an overview of the Swiss, Dutch and the U.K. pension systems, main issues, and corresponding reforms, with special emphasis on the occupational pension pillar (pillar II).** The paper highlights parallels as well as differences among the three systems with the intention to bring out implications and possible options for Switzerland. It picks up on certain features of occupational pension schemes in these countries without intending to describe in full detail all nuances.[44] In understanding the differences among the three systems, it is useful to make a distinction between the U.K. where pillar I is conceived as a "safety net" and Switzerland and the Netherlands where public pensions are viewed as an important source of retirement income going forward. This has implications for the design of pension reform objectives and the related lessons from cross country experience.

93. **One key conclusion of the paper in light of these cross country experiences is that the various administrative constraints imposed on Swiss pension funds may be excessive and limit the efficiency of pillar II.** Indeed, there seems to be scope to relax some of the regulatory imperatives that currently limit risk management options of pension funds in Switzerland. The Dutch system, and also the evolving U.K. approach, provide examples of alternative and more market-based systems that are designed to allow institutions manage their risks more freely, with a monitoring system developed by the supervisors with clear and objective triggers for action. In this context, the *Dutch system* provides an example of a trend towards the introduction of a *risk-based funding requirement* to the pension system. The *U.K.* in turn adopted long-term funding requirements for occupational pension schemes, and has strengthened the emphasis on *transparency and disclosure*. Both these approaches offer some "best practices" that are useful for consideration in Switzerland as well.

94. The paper is organized as follows. Sections II, III, and IV discuss the Swiss, Dutch and the U.K. pension systems, respectively, with an emphasis on the regulation and

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[43] Prepared by May Khamis.

[44] U.K. pension policies are somewhat different from those in Switzerland and the Netherlands. A main emphasis in the U.K. is now how to develop a higher level of private savings against the ongoing gradual scaling down of the public pension system.

supervision of the occupational pension pillar and recent reforms.[45] Section V concludes with some potential policy implications for Switzerland.

## B. The Swiss Pension System

**Overview**

95. The Swiss system is a three-pillar system:

- **First pillar.** A mandatory pay-as-you-go (PAYG) system administered by the public sector. Employers and employees contribute one-half each of the equivalent of 5 percent of payroll eligible earnings, with no limit to the total contribution. Any shortfall in the PAYG system is funded with general tax revenues. Such transfers from the budget currently cover about 20 percent of old-age and 50 percent of disability pension benefits in this pillar, amounting jointly to 2.7 percent of GDP. Pension benefits are based on average lifetime annual income (upon which contributions have been made) and years of contribution and are subject to a minimum and a maximum per month—SwF 1,075 to SwF 2,150 per month for 2005. This pillar is conceived as a key source of retirement income. Pensions are indexed to wages and prices (with equal weights) after retirement.[46]

- **Second pillar.** A funded occupational scheme that became mandatory in 1985.[47] Contribution rates are not specified by law but employers are required to *at least* match the employees' contributions—in practice, the proportions are about 40/60 of total contribution. Defined contribution (DC) plans cover 77 percent of beneficiaries (85 percent of private-sector and 38 percent of public-sector employees) and account for about 85 percent of the total number of occupational plans. Most pension plans are organized as special purpose legal entities, the "foundations", that strictly separate the management of the pension plan from the companies. Employers and employees are equally represented in foundation boards.

- **Third pillar.** A voluntary personal supplementary system, where employees and self-employed can take out savings plans tied to retirement.

96. **Target pension level.** An average combined pension level from the first and second pillars of about 60 percent of final salary.

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[45] As noted, the discussion is not intended to be exhaustive of all issues or challenges that the three pension systems face. Rather, to set the discussion in the right country-specific context, the paper describes the general aspects and challenges of the three systems.

[46] Adjustments are made every two years with early adjustment in the case of a CPI increase of more than 4 percent.

[47] The law requires mandatory coverage for employees age 24 and over and earning annual salary for 2005 between SwF 19,350 and the maximum average pensionable salary for social security purposes of SwF 77,400.

97. **Challenges for pillar II.** The average funding ratio for pillar II was about 110 percent until 2001, but then dropped well below 100 percent as a result of the sharp decline in equity prices and persistent low interest rates. Although equities have performed well lately, pension funds have not fully recovered yet. In addition, pillar II suffers from regulatory and supervisory weaknesses (below).

**Regulation and Supervision**

98. Key issues and elements are:

- **Supervision** of pension funds is fragmented and uneven among cantons. The registration and, consequently, the supervision of private pensions is widely dispersed across the cantons of Switzerland. In principle, each foundation is registered with the cantonal office where its headquarters are located and where the major part of the business of the employer is conducted. However, for foundations serving employers who carry on business across the country (example is the transport industry pension foundation) or internationally, registration is with the Federal Office of Social Insurance (FOSI). The Federal Office of Private Insurance (FOPI) supervises life-insurance companies, which manage pension funds under collective insurance contracts. Neither FOSI nor the cantonal offices usually perform on-site inspections. The system is a "reliance" model and each foundation is required to file certain key documents at regular intervals with its office of registration. External auditors and certified pension experts of pension funds are legally obliged to report infractions. Neither FOSI nor the cantonal offices currently have the instruments to carry out adequate supervision of pension funds. However, in case of serious problems supervisors can remove the board and appoint an external administrator.

- **Funding levels** must be maintained at 100 percent plus some cushion to cope with market volatility.

- **In case of underfunding**:
  - funds may request special contributions from fund members or employers;
  - funds may reduce the guaranteed rate of return for 5 years;[48] and
  - under very extreme conditions, funds may demand contributions from pensioners (i.e. reduce their net benefits).

- **The technical discount rate** to calculate the present value of future pension liabilities is not determined by law. However, pension funds currently report their financial positions using a discount rate within a range of 3 to 4 percent (mean 3.9), as recommended by the Chamber of Pension Fund Experts. The continued use of this range despite the decline in interest rates in recent years has the implication that pension fund liabilities are currently underestimated (and therefore overstating the funding level of pension funds). The Chamber has not provided guidelines to lower this range and seems to be divided over

[48] The guaranteed rate of return on pension assets is viewed as a consumer protection devise to prevent pension managers from absorbing returns in excessive management fees.

this issue, in part because of uncertainty whether the current low real interest rates are temporary or a permanent feature of the capital markets.

- **The conversion rate** for private pension funds that translates each individual's invested balance into an annual pension payment from retirement onward, was reduced from 7.2 to 6.8 percent (gradual lowering to 6.8 percent through 2014). In view of the increase of life expectancy and the fall in yields, the Federal Council recommended in January 2006 that the conversion rate be reduced further gradually to 6.4 percent by January 1, 2011.[49] This rate will be reviewed every five years. Given the increase in life expectancy, this rate may still be too high with the implication that a further build up in pension fund reserves may be needed.

- **The guaranteed rate of return** for mandatory occupational schemes was fixed at 4 percent in 1985, but has been revised down to 3½ percent in 2002 and 2½ percent on January 1, 2005. It applies only to the mandatory portion of individual retirement accounts accrued since January 1, 1985. The minimum rate of return is reviewed every two years. Second pillar occupational pension funds are free to choose the extent of price indexation of pensions after retirement, depending on each fund's financial position. This rate, together with the conversion rate, introduce a defined-benefit component into DC occupational pensions.

- **Asset allocation** restrictions are in place through specific regulatory quantitative limits on investment in various asset classes. These restrictions can be lifted by the pension scheme with justification, and provided that the fund can prove satisfactorily its ability to manage its portfolio prudently. Quantitative restrictions have been relatively eased since 1985. However, remaining restrictions may hamper risk management abilities.

- Foundation boards also put strong emphasis on prudent man rules.[50] Strategic asset allocation decisions are made by the foundation boards while, typically, a subcommittee of the board, the investment committee, implements the strategy through internal and external fund managers.

- **Apart from the above noted conditions, pension funds have substantial flexibility in setting their terms and conditions** such as the rate of contribution, and the choice of plan type.

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[49] The new proposed conversion rate is based on an average expected return on assets of 3.85 percent and a discount rate of 3.35 percent. The proposal is pending Parliamentary approval.

[50] That is, assets should be managed prudently to achieve a reasonable investment return, diversify risks and maintain a suitable degree of liquidity.

- **Accounting rules:** Swiss accounting standards (FER 16). In 2005, Switzerland implemented the IAS 19[51] accounting standard for all internationally active corporations.

- **Reporting and disclosure requirements** were strengthened in 2004. Reporting and disclosure to fund members were enhanced. An annual funding review of all pension funds by FOSI was introduced based on data provided by the cantonal supervisory authorities. The objective of this review is statistical as FOSI does not have any supervisory authority over pension funds. FOSI submits it final report based on this review to the Federal Council around year-end; i.e. at a 12-month lag after the end of the reporting period. FOSI also introduced a voluntary annual survey conducted directly with pension funds to evaluate the risk capacity of these funds. Annual reports of Swiss pension funds are published.

- **Pension benefit guarantees**. The Guarantee Fund charges premiums that are proportional to pension funds' size but are not risk-based.[52] It also subsidizes institutions with an unfavorable age structure.

### Recent Reforms

99. **The Occupational Pension Law (BVG) has been amended in three stages during the period 2004–2006 and a number of reforms were introduced as a result (Box 1)**:

**Box 1. Switzerland—Amendments to the BVG Law, 2004–06**

Amendments to the BVG Law were made in three stages:

- **The first stage,** implemented in April 2004, focused on improving transparency and reporting standards.

- **The second stage,** implemented in January 2005, expanded worker coverage through lowering the earnings threshold for coverage, raised retirement ages for women from 63 to 64 (establishing equivalence with an earlier reform that applied to the first pillar), lowered the annuity conversion rate from 7.2 to 6.8 percent, and mandated certain new benefits similar to those in the first pillar such as widower's pensions and additional categories for disability pension.

- **The third stage** comprised the Swiss Federal Council passing further revisions to the law to permit greater flexibility in plan design, to reduce the potential for disproportionate employee tax advantages, and to increase the minimum age for early retirement from age 55 to 58. Beginning January 1, 2006, pension funds will have 5 years to amend their rules and modify operations accordingly.

100. **In addition, to address the immediate issue of underfunding, pension funds introduced a series of measures in 2004 (Table 1):**

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[51] Under IAS 19, Companies with DB plans are required to include underfunding of their pension schemes into the Statement of Recognized Claims and Losses. For DC plans where a company's only obligation is to make contributions, the company's contribution is charged as an expense on the income statement, and there is no balance sheet liability.

[52] The fund guarantees statutory benefits owed by insolvent pension funds up to one and a half times the upper limit of the insured salary (i.e. SwF 116,100 for 2005).

Table 1. Corrective Actions by Swiss Pension Funds, 2004

| Corrective action | Number of funds 1/ |
| --- | --- |
| Reduction in benefits | 36 |
| Higher employer contributions | 13 |
| Higher employee contributions | 10 |

1/ As percent of total number of funds.

101. **Moreover, further reforms were proposed more recently**. As noted above, the Federal Council recommended in January 2006 that the conversion rate be reduced gradually to 6.4 percent by January 1, 2011. Additional potential reforms are in the early stages of discussions, such as: (i) the standardization of the regulatory framework for pension funds through the creation of a High Supervisory Board that is financially and legally autonomous and responsible for issuing uniform regulations for the industry; (ii) the full decentralization of pension fund supervision to cantons (or a collection of cantons); (iii) moving away from administratively set technical parameters and asset restrictions; and (iv) a more proactive role for the industry in setting up standards, including quality requirements for auditors.

102. **Particularly, in relation to item (iii) above, a committee of experts made important recommendations in late 2005 to**: (i) abolish the minimum guaranteed rate of return; (ii) abolish the minimum limit on the discount rate and only establish a maximum limit; (iii) make the necessary legal amendments so that the conversion rate can be changed by a decision of the Federal Council instead of the Parliament; and (iii) abolish quantitative restrictions on asset allocation and replace them with adequate asset-liability management. These are important proposals that address the core of the regulatory constraints of pillar II.

103. **As regards the supervision of pension funds, the expert committee has proposed a redesign of the supervision framework**, with a proposal to give a “High Supervisory Board”, possibly within FOSI, the mandate to safeguard the financial stability of pension funds and to harmonize the activities of the cantonal supervisory authorities. This Board would be responsible for issuing general directives to ensure the standardization of regulations throughout the country while the cantons will be fully responsible for pension fund supervision. The proposed system, however, does not seem to address variations in supervisory practices among the cantons.

## C. The Dutch Pension System

### Overview

104. The Dutch pension system is also a three-pillar system:

- **First pillar.** A compulsory PAYG public pension system. Premiums are levied on taxable income at a rate of 17.4 percent with a maximum contribution limit (currently at €5,288). People with no income still accrue the benefit entitlement. Shortfalls in the PAYG system are funded with general tax revenues. Benefits guarantee 70 percent of the statutory social minimum wage with no means-testing.[53] Similar to Switzerland, this pillar is viewed as a key source of retirement income. The retirement age to qualify for this pension is 65 for both men and women. The entitlement builds up by 2 percent for each year of residency between ages 15 and 64, leading to a 100 percent entitlement at age 65.[54]

- **Second pillar.** A complementary private occupational pension system. It is non-compulsory, but 92 percent of all workers in the Netherlands participate in it. It is predominantly a defined benefit (DB) system. There is no general statutory obligation for employers to make pension commitments to employees, but data indicate that average employer contributions are around 78 percent of all premiums.

- **Third pillar.** An individual savings account system managed by private insurance companies. It is primarily used by small businesses (the self-employed) and also by people with gaps in building up an occupational pension.

105. **Target pension level.** For many years, the authorities aimed for combined benefits from the first and second pillars of 70 percent of the last earned income. A recent reform (see below) lowered this to 60 percent.

106. **Challenges for pillar II.** The system faced solvency problems in the early 2000s due to asset valuation losses as a result of the decline in equity prices and persistently low interest rates.[55] The average funding ratio for the system against nominal liabilities declined from 150 percent in 1999 to a 108 percent in 2002, and around 15 percent of pension funds were below 100 percent. As in Switzerland, the average funding ratio improved after 2002.

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[53] Seventy percent of the net minimum wage for a single person, 90 percent of the net minimum wage for a single parent with an unmarried child under 18, and 100 percent of the net minimum wage for a married person or a person living together with a partner (i.e. 50 percent each).

[54] Those living outside the Netherlands for part of this period will receive reduced benefits unless they voluntarily continue participation while living abroad.

[55] Equity investments had increased from 10 percent of total in 1990 to 40 percent in 2000.

As of end-2003, the average funding ratio was estimated to have increased to over 110 percent.[56]

**Regulation and Supervision**

107. Key elements are:

- **Supervision.** The Netherlands has recently adopted a cross-sectoral functional approach to supervision.[57] Within this approach, two supervisory agencies focus on specific supervisory objectives, namely, (i) the soundness of financial institutions and, (ii) the conduct-of-business objective of enhancing orderly and fair market practices. Accordingly, all prudential supervision was consolidated into a single body within the central bank by merging the supervisory unit of the Netherlands Central Bank (DNB) and the Pension and Insurance Supervisor (PVK). All conduct-of-business supervision was consolidated within the Authority for Financial Markets (AFM). Covenants were established between the two supervisors to ensure good coordination and cooperation.

- **Funding levels.** See below under recent reforms.

- **In case of underfunding**, pension Boards (governed by employers and employees) can change the pension terms including benefit provisions subject to a new risk-based supervisory system (see below under recent reforms).

- **Discount rate.** Consistent with IAS 19. Based on market yields at the balance sheet date on high quality corporate bonds for the same currency and duration of liabilities. If the market for corporate bonds is not liquid, the market yields on government bonds is used with some adjustment to compensate for risk. These guidelines replaced a previous rule that required the use of a discount rate of 4 percent.

- There is no administratively set **conversion rate** or a **minimum guaranteed rate of return**.

- **Asset allocation.** The investment policies of the pension funds are reviewed by the supervisor and funds are required to be "invested in sound manner", but consistent with the risk-based approach, there are no specific prescriptions for asset allocation.

- **Accounting rules.** Dutch Accounting Standard (DAS) 271 and IAS 19.

- **Pension benefit guarantees.** There is no guarantee scheme for pension funds.

[56] Source: IMF (2004), *The Netherlands—Technical Note: Pensions Sector Issues*, Financial Sector Assessment Program.

[57] The reforms began in 1999 and are currently in the last stages.

**Recent Reforms**

108. **To address the solvency issues in the second pillar system and to limit the potential for their reoccurrence, several far-reaching reforms were adopted recently (Table 2):**

Table 2. Corrective Actions by Dutch Pension Funds, 2002–04

| Corrective action | Number of funds 1/ |
|---|---|
| Higher contribution rate | 79 |
| Changes in price indexation 2/ | 67 |
| Move to a career-average basis | 23 |
| Undertake a subordinate loan from sponsor | 16 |
| Reductions in benefits | 10 |

1/ As percent of total number of funds.
2/ Includes the selection of conditional indexation.

- **Contributions were raised.** On average, the contribution rate (as a share of wages) has increased from 9.5 percent in 2000 to 16.3 percent in 2004.[58]

- **Price indexation of benefits was cut.** Pension Fund Boards came to the view that contribution rate increases required to maintain full price indexation may be too high and may unduly harm the labor market. Most pension funds therefore opted for conditional clauses that linked indexation to fund performance.[59] Furthermore, the basis for benefits was moved from final salary to average salary.

- **A new risk-based supervisory framework was introduced.** The Principles of the Financial Supervision of Pension Funds, which came into effect in March 2004, required funds to restore coverage of their nominal liabilities to 130 percent within a period of 15 years. A new Pension Act elaborated these Principles and introduced a risk-based supervisory framework, the Financial Assessment Framework (Box 2). The framework introduced new guidelines for assessing the financial position of pension funds including a risk-based funding requirement that takes into account the risks inherent in a pension fund's asset-liability mix. The new framework involves additional reporting and disclosure requirements.

[58] Source: IMF (2005), *Kingdom of the Netherlands—Netherlands—Selected Issues*, IMF Country Report No. 05/225. The rates and the increases vary from one pension fund to another.

[59] Under conditional indexation, pension indexation is dependent on the annual decision of trustees and typically is subject to economic conditions and investment performance of assets. In practice, many pension funds have opted for the conditional form of indexation. The Dutch regulators are strengthening transparency requirements and are requiring companies to make clearer whether they apply a "conditional" or "unconditional" inflation-indexation policy.

**Box 2. The Netherlands—The New Financial Assessment Framework for Pension Funds**

Effective January 1, 2007, pension funds in the Netherlands will be subject to new tests of funding adequacy and additional reporting and disclosure requirements. Three parallel funding tests will be applied:

- *A minimum funding test,* requiring pension funds to maintain a minimum of 105 percent funding ratio at all times.

- *A continuity test,* containing a long-term projection of the solvency position and a "stress" analysis. It shows the results of the minimum funding and solvency tests, performed annually, projected over the next ten years. This test requires funds to describe policy goals and types of policies, and economic assumptions and projections including with respect to short-and long-term interest rates, investment returns, and inflation.

- *A solvency test,* which introduces an innovative risk-based framework for pension fund management. The risk parameters of pension fund assets would be set so as to guarantee at a 97.5 percent confidence level that the funding ratio will stay above 105 percent over one year (taking into account the expected contribution and expenses during the year). In cases where indexation is not guaranteed, and given certain assumptions, the latter implies a funding ratio, on average, of 130 percent (the current average is 124 percent), to be met within a period agreed on with the supervisor not exceeding 15 years. However, if the ratio falls below 105 percent, it has to be restored within one year, except at times of severe macroeconomic downturns or systemic risk, in which case more latitude would be given. Pension funds can either use their internal models or standard calculations, in a way that resembles the Basel II framework for bank capital adequacy. For most calculations, assets would be marked-to-market, and liabilities would be discounted along the government yield curve with some risk adjustment (depending on their term to maturity). Liability assessments would also include a two year increase in average life spans.

## D. The U.K. Pension System

### Overview

109. Although it has a number of special characteristics, the U.K. pension system can also be characterized as a three-pillar system:

- **First pillar.** A two-tier public pension system, which is viewed as a safety net (similar to the U.S., New Zealand, Canada, and Ireland), rather than as an important source of retirement income as in the case of Switzerland and the Netherlands. The first tier is a flat-rate benefit known as the Basic State Pension (BSP), currently £328 per month to individuals who have worked at least 39 years.[60] The second is the earnings-related State Second Pension (S2P) to supplement the BSP. Employees with earnings in excess of a Lower Earnings Limit (LEL) will automatically be members in S2P, unless they belong

[60] The amount of BSP depends on the number of qualifying years built up before retirement. Those with fewer years of employment receive a smaller benefit. In addition to the BSP, there is a top-up means-tested Pensioner Credit for lower income pensioners.

to an employer's occupational plan or to a personal pension scheme that has been contracted out of S2P.[61] The self-employed are entitled to the Basic Pension but not to the S2P. State pension age is 65 for men and 60 for women.[62] The BSP is indexed to the higher of 2.5 percent or retail price inflation after retirement.

- **Second pillar.** Comprises voluntary occupational pension schemes and are fully indexed to prices after retirement (up to 5 percent per year for most schemes). Employers and employees contribute to this pillar. Over the last 25 years, there has been a decline in the number of active members in private sector occupational pension schemes, accompanied by a major shift from DB to DC schemes. These changes have accelerated in the last 10 years.

- **Third pillar**. Comprises personal individual or group pension schemes, offered and managed by private pension providers. These schemes provide alternatives for the self-employed or people with gaps in their occupational pension. Employer-sponsored pensions can also be provided via group personal pension scheme. In these cases, the legal contract is between the individual and the insurance company provider, but with the employer facilitating the process, negotiating the charges, and usually making a contribution. Options include contracted out schemes.[63]

110. **Target pension level.** No explicit target. The combined income levels of the public and private pension systems for the average pensioner has recently been just around 69 percent of income before retirement (Table 3).

111. **Challenges to pillar II.** Many DB schemes are winding down as a result of increasing costs of providing pensions because of increasing longevity, lower returns on assets, and lower interest rates. New accounting rules requiring firms to reflect any underfunding of pension funds on the Statement of Recognized Claims and Losses has also meant that volatility of the funding ratio, arising from the mismatch between the risk characteristics of assets and liabilities, could transfer to the company's balance sheet. Since the 1980s, in the face of an aging population, the government started to lower public pension support and cut costs in the first pillar. However, this has led to concern that the levels of

[61] "Contracting out" means that on retirement, an employee's second pension will come from an occupational or private scheme rather than from the S2P. Schemes can only be contracted out of S2P if they meet certain conditions. The employer and employee pay lower National Insurance Contributions to compensate for the additional State Pension that the employee has given up. In this context, occupational and private pensions can be viewed as a substitute for S2P.

[62] The Thatcher Government raised the state pension age for women to 65 over a ten-year period beginning 2010.

[63] Contracting out into a personal pension scheme was first allowed in 1978. This resulted in an increase in the number of people covered by private pension schemes and a reduction in the number of people covered by Pillar I's second tier. This trend was reversed from the mid 1990s largely as a result of the "mis-selling" scandal of personal pensions that erupted in December 1993.

savings in the private pension system (Pillars II and III) may not be adequate to offset the reduction in state benefits.[64]

**Regulation and Supervision**

112. Key elements are:

- **Supervision.** The Pensions Regulator supervises occupational pension schemes. (The Financial Services Authority regulates life insurance and fund management companies.)

- **Funding levels.** New regulations (2005) emphasize the long-term solvency of pension funds coupled with a strengthened regime of disclosure and transparency (Box 3). In the new regulations, the Minimum Funding Requirement (MFR) for pension plans was replaced with a long-term, scheme-specific funding standard.

- **In case of underfunding** the scheme has to provide a “recovery plan” for returning to full funding within ten years, but trustees are encouraged to move faster (i.e. within three to five years). The Pensions Regulator has the power to provide extensions to the time limits, based on each fund’s circumstances.

- **The discount rate**. Market-based. Under Financial Reporting Standard 17 (FSR 17), actuarial liability is calculated using the current rate of return on a high quality corporate bond (rated AA or above) of equivalent currency and duration to the scheme liabilities, or in the absence of such bonds, government bonds plus a margin for assumed credit risk spreads derived from global bond markets.

- **No guaranteed rate of return.** Pension benefits are indexed to prices (up to 5 percent annually for most schemes). No regulatory **conversion rate.**

- **Accounting rules.** FRS 17, which is similar to IAS 19, was issued by the Accounting Standards Board in 2000. Pension funds are required to start its implementation in their 2006 financial statements. Effectively, the new standard has been fully adopted already.

- **Reporting and disclosure.** Associated with the new funding regulations there is a strong regime of disclosure and transparency. A communication strategy is required to be developed to make certain plan members are informed about the funding of their pension plan. Scheme members and their representatives, unions, and the company’s shareholders can scrutinize the scheme’s findings and investment plans.

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[64] A 2004 Pension Commission report estimated that at least 75 percent of all DC scheme members have contribution rates below the level likely to be required to provide adequate pensions. In addition, it is estimated that around 9 million people may be under-saving, some severely.

**Box 3. The U.K.—Main Elements of the New Funding Standard for Pension Funds 1/**

Based on the 2001 Myners review of institutional investments, a new funding standard was introduced that replaced the MFR. The main elements of the new standard are:

- The Trustee and Advisors for each scheme are required to publish a scheme-specific funding statement, a Statement of Funding Principles (SFP), which sets out in a clear and straightforward way how it sees its liabilities growing over time and how, through contributions to the fund and growth in the value of assets, it proposes to meet its liabilities. The SFP also sets out assumptions used for projecting its liabilities, including the range of economic scenarios considered. The SFP is intended to complement the Statement of Investment Principles prepared by trustees.

- The SFP should include a "recovery plan" for restoring an underfunded plan to fully funded status. This should be as quickly as the employer can reasonably afford. The Pensions Regulator is likely to intervene if this is longer than 10 years.

- The employer is expected to be fully involved in the discussion about funding and investment plans, and in agreeing to the contribution rates.

- The Pensions Regulator has the authority to establish employer contributions if the employer and trustees cannot reach an agreement on the content of the SFP.

- A schedule of contributions, certified by the actuary, is mandatory.

- Regular actuarial valuations are conducted (required at least once every three years). Trustees determine the actuarial methods and assumptions used, in consultation with the plan actuary.

- Under the new standard, the trustees, actuaries, and auditors have whistle-blowing duties to report to the regulator, particularly in cases where contributions are not being paid according the published funding statement

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[1] This Box draws heavily on Blake (2003).

- **Pension benefit guarantees.** A Pension Protection Fund, introduced in 2004, guarantees DB schemes that are winding up (and all schemes where there have been instances of fraud). The Fund is introducing risk-based premiums and must approve the conditions of takeovers where the acquired firm's scheme is underfunded.

## Recent Reforms

113. **The Pensions Commission was appointed in December 2002 with the objective of reviewing the adequacy of private pension saving in the U.K., and advising on potential policy changes**, including whether there is a need to move beyond the voluntary approach for earnings-related private pension savings. The Commission published its recommendations in December 2005 and final report in April 2006. The Commission concluded that:

- The current system of private funded pensions combined with the current state system will deliver increasingly inadequate and unequal pensions; almost half of the working age population over 35 (mostly middle-income earners) is not saving enough to meet likely expectations of retirement income.

- These problems were not soluble through changes to the state system alone, nor by incremental measures to encourage voluntary provision.

- Reforms should instead deal with the major gaps which existed in the current state system and overcome the barriers of inertia and high cost which deter voluntary private pension provision.

114. **The main proposals of the Pensions Committee included a restructuring of the public pension system** and accelerating the withdrawal from its earnings-related pension provision (i.e. S2P), while a proposed National Pension Savings Scheme for private savings would provide a proven alternative (Box 4). In the long-term the Pension Commission proposals would entail a mixture of increased taxes earmarked for pensions and an increase in state pension ages. However, it is reported that the proposal to abolish means-testing and index state pensions to earnings is seen as too costly by the U.K. Treasury with the expectation that the proposal will involve higher government spending, especially during 2010-2020. The Treasury's view is that this spending would have to compete with other government priorities and should be considered as part of the Comprehensive Spending Review. The Government is expected to release a government white paper on pension reform, responding to the Commission's proposals, in the spring.

**Box 4. The U.K. –Key Proposals of the Pensions Commission**

The main proposals of the Pensions Commission report include:

- **A restructuring of the state pension system** to make it "as non-means-tested flat rate state pension provision as possible, with the state withdrawing gradually from its role in PAYG earnings-related pension provision (i.e. S2P) as the NPSS (below) provides a proven alternative to earnings-related system". The Committee recommended that, by 2030, the S2P should be gradually changed from an earnings-related to a flat-rate benefit by freezing the upper-earnings limit for accruals in nominal terms. The Means-Tested Pensioner Credit, which is viewed as a disincentive to personal savings, should be eliminated. The basis for receiving BSP benefits are to be changed from the number of years of active employment to one of residency, to compensate women for work years that are interrupted to raise children and as caregivers. Indexation is proposed to be changed from average growth in prices to average growth in earnings beginning around 2010.

- **Automatic enrollment** into a nationally-administered DC pension fund, the NPSS, with the right to opt-out, and with a compulsory employer contribution. (The NPSS would be financed by an 8 percent contribution rate comprising 4 percent workers' contribution, 3 percent employers' contribution; and 1 percent tax relief or credit.) The self-employed would be allowed to participate on a voluntary basis. This proposal is designed to address the lack of growth of DC or similar long-term savings schemes and the high charges associated with private pensions. Automatic enrollment is thought to increase pension savings because historically such schemes have shown that most people do not opt-out.

- **Raising the statutory retirement age**, in proportion to the increase in life expectancy to about 67 years by 2050, and to introduce various incentives for people to work longer.

## E. "Best Practices" and Implications for Switzerland

115. **In common with many other countries, the Swiss public pension system is facing growing financial pressures due to its aging population.** The existence of a high level of savings in the private pension system renders these challenges easier to manage in Switzerland compared to several other European countries. Nevertheless, it is important to build upon this achievement, not the least by targeting reforms in the pension system similar to progress made in other sectors in the financial system. The occupational pension pillar in Switzerland faces important challenges primarily regarding fragmented supervision and the predominance of administratively set parameters. Recent reforms implemented in the Netherlands and the UK provide useful examples of new approaches. In particular, pension system reforms in Switzerland should focus on the following areas:

- **Strengthening the supervision of pillar II and unifying the system of supervision.** A single central office should be given the responsibility of pension supervision throughout the country to ensure the application of uniform supervision.[65] In addition, there is a need to implement more timely reporting standards. The authorities have made related proposals recently; and an expert committee has suggested a redesign of the structure of pension fund supervision with a "High Supervisory Board" issuing general directives to

[65] A reiteration of the 2001 FSAP mission recommendation, which continues to be valid at this date.

ensure the standardization of regulations throughout the country while the cantons would remain responsible for supervision. This proposal is a step in the right direction but does not adequately address variations in supervisory practices among the cantons.

- **Liberalizing the pension regulatory framework.** Under the current system, Swiss pension funds are constrained by regulatory imperatives that weaken the risk management options of pension funds and may limit the long-term resiliency of pillar 2. Consistent with cross country experience, there is an scope to remove these restrictions, both on the asset side (e.g., direct investment regulations) and on the liability side (e.g., centrally-determined guaranteed rates of return, the technical discount rate, and the conversion rate). Although these parameters are modified periodically, they do not adequately reflect changing market and demographic conditions. In this context, the recent recommendations of the Committee of experts to move away from administratively set technical parameters and restrictions are welcome. Reforms in this area should be complemented by enhanced disclosure and transparency, similar to the U.K. system.

- **Consistent with the above recommendations, consideration should be given to reorienting the supervisory framework to a more risk-based system** consistent with supervisory changes that are currently being implemented in the banking and insurance sectors under Basel II and the new Swiss Solvency Test (SST). The newly introduced Dutch system provides an example of this approach.

The Swiss FSAP update scheduled for end-2006 can be a good opportunity to explore these and other issues in more detail.

## Table 3. Occupational Pension Systems in Switzerland, The Netherlands, and the U.K.

| | Switzerland | The Netherlands | The United Kingdom |
|---|---|---|---|
| **Total assets (as percent of GDP) 1/** | 111.6% | 106.2% | 65.1% |
| **Participation rate 2/** | Mandatory 3/ | 92% | 56% 4/ |
| **Discount rate** | Mean 3.9% | Market-based | Market-based |
| **Conversion rate** | 6.8% | Not prescribed administratively | Not prescribed administratively |
| **Minimum rate of return** | 2.5% | Indexation to prices. Could be either unconditional or conditional on fund performance. | Indexation to prices (up to 5% per year) |
| **Overall replacement rate (Public and private pensions) 5/** | 81% | 78% | 69% |
| **Benefit system** | Predominantly DC (77%) 6/ | Predominantly DB (95%) 6/ | Predominantly DB (84%) 6/ |
| **Supervisory framework** | | | |
| **Supervisory Agency** | Federal Office for Social Insurance | The unified supervisory unit of the Netherlands Central Bank and the Pension and Insurance Supervisor; and Authority for Financial Market | The Pensions Regulator |
| **Minimum coverage ratio** | Funding ratio should stay above 100 percent plus some reserves to cope with market volatility | Risk based. Funding ratio should stay above 105 percent over one year at a 97.5 confidence interval | Published funding statements coupled with a strong regime of disclosure and transparency |

1/ Source: OECD, Global Pension Statistics. Data reflect total self-administered pension fund assets as of end-2004.
2/ Number of workers participating in pillar 2 as a percentage of total employees.
3/ The fraction of the labor force not participating in occupational plans include the self-employed, employees with salaries below the mandatory limit, part-time employees and employees with more than one employer.
4/ Source: U.K. Pensions Commission (2004).
5/ Source: IMF, Global Financial Stability Report, September 2004. Pension income, just after retirement, as a percentage of total income just before retirement, for an average two-person household; excludes sources on income other than pension.
6/ As share of total employees.

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