Media documentation

Date: 21 November 2012

Guidelines for the Pensions 2020 reform program

The guidelines in this document are based on the following objectives: maintenance of the level of benefits under the 1st and 2nd pillar, financial consolidation of the pension system and management of costs related to AVS and AI supplementary benefits.

In particular, these guidelines cover issues related to retirement, the adjustment of the minimum conversion rate and compensatory measures, including measures for the intermediate generation. Institutional aspects are also taken into account with a view to improving transparency. Furthermore, this document also addresses AVS-related financing issues, particularly with regard to benefits and contributions, as well as additional financing and the introduction of an intervention mechanism.

The Federal Council has instructed the Federal Department of Home Affairs to set out the key tenets of "Pensions 2020" on the basis of this document's guidelines, and to present its findings to the Federal Council by mid-2013.

Contents

1. Social policy

1.1. Outlining social policy

Social policy over the next 10 years requires a holistic approach for better mutual coordination of its individual strands; a policy that is global in outlook and does not merely view aspects of the welfare system in isolation. Assessing individual social insurances separately is advantageous in that it can help to resolve problems as and when they arise. However, this approach takes insufficient account of the numerous interconnections between the different aspects of social security. An overall evaluation of social policy seeks to achieve coherent, balanced solutions, notably in order to meet the challenges facing our society in relation to economic and demographic trends. An integrated approach ensures that the necessary changes related to social insurance are put into practice in a consistent manner and, at the same time, that social policy focuses on clearly defined social and material goals to help strengthen social cohesion.

In the broadest sense, social policy covers all measures at legal level as well as action plans and impulse programmes over the next 10 years in relation to social insurance for which the FDHA is responsible. As concrete action is a matter of priority in this regard, this discussion paper focuses on the reform of the 1st and 2nd pillar within the pension system. The necessary law changes must be submitted to parliament during the current legislative period in order to take effect from 2020.

Based on this document's guidelines, the FDHA will set out the key tenets of "Pensions 2020" and submit these to the Federal Council by next summer.

1.2. Social objectives

A variety of objectives determine social policy. Since social policy affects everyone, solutions to the relevant problems must, above all, meet the legitimate expectations of all those concerned. Policies should therefore ensure adequate cover for risks and, in particular, pay due account to the needs of vulnerable groups in society. Financial consolidation cannot be achieved without public backing. It is therefore essential that people understand and accept the necessity of the approach being taken. For this reason, social policy must offer convincing solutions that take account of stakeholders' demands and concerns. That social policy is as transparent as possible is equally important – in order to give people peace of mind when it comes the future of their social insurances. A lack of trust would jeopardize the equilibrium of our welfare system, which is based on the principle of solidarity. To achieve its various objectives, social policy must be coherent and follow a holistic approach.

1.3. Material objectives

In view of the principles referred to above, social policy focuses primarily on the following material objectives:

- Guaranteeing secure and adequate social benefits;
- ensuring the sustainable financial equilibrium of the social insurances;
- Strengthening transparency in relation to the management of social insurances, particularly under the 1st and 2nd pillar, in order to increase trust in the social security system
- Combating poverty by improving synergies between social insurances and by putting greater emphasis on the professional re-integration of risk groups

A well-conceived and implemented social policy not only achieves equitable results but is also an essential prerequisite for growth and economic development. Balanced growth, for its part, has a positive effect on the development of social insurances. Social policy should enable the social security system to reflect changing conditions in our society on an ongoing basis.

2. Guidelines for the Pensions 2020 reform program

2.1. Background

2.1.1. Current challenges

Switzerland's three-pillar system faces challenges that require medium to long-term solutions. Decisive steps have already been taken to ensure a healthy financial basis in the case of invalidity insurance but this is not the case in terms of the Old-Age and Survivors Insurance (AVS) and occupational benefit plans (PP) – two schemes which, as a result of political impasses, are struggling to adapt to social trends and, in particular, to structural, economic and demographic changes. Both drafts of the 11th AVS revision were rejected – the first draft in the 2004 referendum (draft was submitted simultaneously to a 1% increase in the portion of VAT used to finance the AVS and the Invalidity Insurance AI), the second draft in the National Council's final vote in 2010 following several years of deliberation in parliament. A bid to adjust the minimum conversion rate fixed in the Federal Law on Occupational Benedit Plans (LPP conversion rate) fell foul of a referendum in 2010. This emphatic rejection clearly shows that any proposed solutions must take the Swiss population's expectations and concerns more into account. Should proposals to reform the pension system fail again, this would result in considerable risks. If measures are not approved within a reasonable period of time, the process of establishing financial stability for the 1st and 2nd pillar will drag on longer than it ought to. Possible transitional measures to cushion the impact of expected changes could be jeopardized as a result.

To increase the chances of the necessary changes taking effect, existing impasses must be overcome. A comprehensive reform of the pension system therefore requires a holistic approach. This entails finding overall solutions to shared demographic and economic problems on the one hand, and also dealing with specific problems concerning the individual systems on the other.

2.1.2. Preparing the ground

After the most recent pension revisions were rejected in 2010, the FDHA carried out preparatory work with a view to re-aligning the reform proposals in a consensus-friendly manner.

In terms of the AVS, a technical revision enabled speedy implementation of the non-contested provisions of the 11th AVS revision. Parliament unanimously approved this revision in 2011, resulting in noticeable improvements related to AVS implementation from 1 January 2012.

Various stakeholder consultations demonstrated a measure of consensus with regard to the AVS's financing scenarios, which were adapted in line with ongoing demographic and economic parameters. An agreement was also reached on research work aimed at resolving complex socio-demographic and financial issues. This work was completed on schedule in autumn 2012. The corresponding studies were published[1] and their results discussed by the Federal AVS/AI Commission. Their key conclusions are explained below (see sections 2.3.2.1 and 2.3.5) and will be used as input in legislative proceedings.

In relation to occupational benefit plans, a comprehensive report was produced in 2011 regarding the future of the 2nd pillar. The report provides an overview of current problems and a run-down of possible solutions. Reactions to this report were published and summarized in a document that can be viewed on the Federal Social Insurance Office website. The various opinions expressed in this document are proof that key issues such as adjusting the LPP minimum conversion rate or increasing the retirement age remain contentious. In some quarters, people are questioning the necessity of decreasing the

[1] To consult the publications in question, please visit the Federal Social Insurance Office website.

conversion rate. There is considerable disagreement on how any adjustment would be managed.

In connection with the draft proposal for an adjustment to the minimum conversion rate which was rejected in the 2010 referendum, the Federal Council fulfilled the legal mandate that requires a report to be drawn up every 10 years regarding the minimum conversion rate (Art. 14 para. 3 LPP). The reform of the pension system covers measures related to the future of occupational benefit plans.

Finally, two respective studies[2] – on 2nd-pillar administrative costs for provident institutions and employers and on the costs of asset management – were completed and published in 2011.

2.2. Current financial situation and outlook

2.2.1. Demographic and economic challenges

Demographic and economic trends have an effect on the entire pension system. However, their impact on the 1st pillar and 2nd pillar differs. **The pay-as-you-go system**, which involves maintaining a balance between ongoing income and expenses, is currently subject to scrutiny owing to structural changes in the age pyramid (lower birth rates and higher life expectancy). Longer pension payment periods, meanwhile, are having an impact on **funded pension schemes**, in that individual assets are having to be spread over a longer period than currently provided for by the LPP conversion rate.

The economic implications for the 1st and 2nd pillar also vary. The **AVS** scheme is benefiting from a favourable economic trend, as positive figures normally lead to higher wage bills. In the long term, total pensions should also increase owing to the enhancing effect on annuities. However, because they are established on the basis of the composite index (arithmetic average of the wage index and price index), pensions are rising more moderately than wages. This mechanism therefore has a stabilizing effect on the AVS's financing.

For **occupational benefit plans**, there is no economic trickle-down. Wage bill and employment growth only has a marginal impact on these schemes, while the effect of the economy on investment returns is unclear. In this context, it should also be noted that investment returns are influenced considerably by earnings generated abroad. Achieving returns over the long term that exceed wage growth and inflation, regardless of the state of the economy, is essential for the sustainability of occupational benefit plans.

The AVS and AI supplementary benefits are an integral part of the 1st pillar and are influenced significantly by demographic trends. Two aspects are key in this regard. Firstly, expenditure depends on the number of AVS or AI recipients and their financial situation, and, secondly, on health costs generated by higher life expectancies[3]. The economic environment has no direct impact on supplementary benefits, given that these are financed by the Confederation and cantons. However, the prevailing economic parameters determine tax revenue and can consequently influence the financing of supplementary benefits.

2.2.2. The AVS's financing outlook

Thanks to various financial measures that have been implemented since the end of the 1990s[4] as well as the positive influence of bilateral agreements and migration, demographic factors still do not exert any great pressure on AVS accounts. Nevertheless, a decreasing

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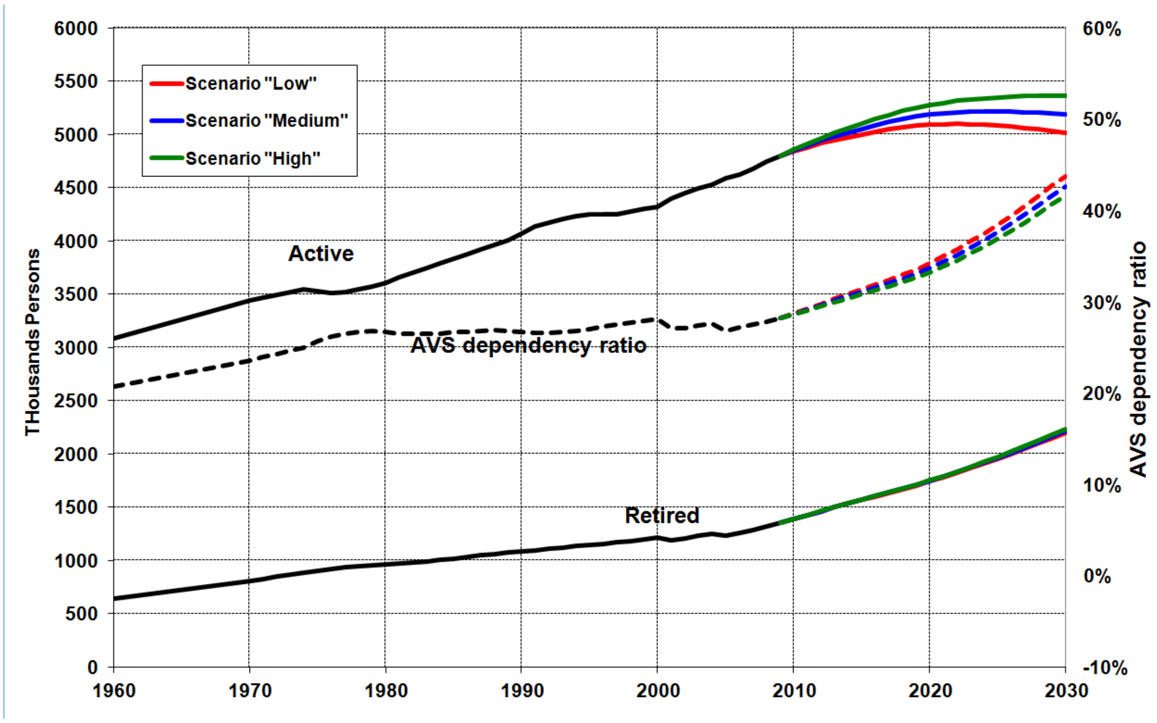
[2] *Verwaltungskosten der 2. Säule in Vorsorgeeinrichtungen und Unternehmen und Vermögensverwaltungskosten in der 2. Säule*, Beiträge zur Sozialen Sicherheit 3 und 4/11, 2011 – see Federal Social Insurance Office website

[3] Other factors apart from demographics have an effect on health costs.

[4] Allocation of a portion of VAT to finance the AHV since 1999 and revenue from the tax on gambling clubs since 2000; payment of the proceeds from the SNB's gold sale; gradual increase in the retirement age for women from 62 up to 64 in 2005.

birth rate – together with higher life expectancy – will widen the gap between active workers and pension recipients. This imbalance is likely to increase in the 2030s when the second babyboom generation of the 1970s begins to reach retirement age. The following diagram shows the old-age dependency ratio curve in real terms over the past decades as well as projected scenarios for the future, based on various demographics-related assumptions ("low" net migration scenario of 30,000 people; "middle" scenario: 40,000 people; "high" scenario: 50,000 people).

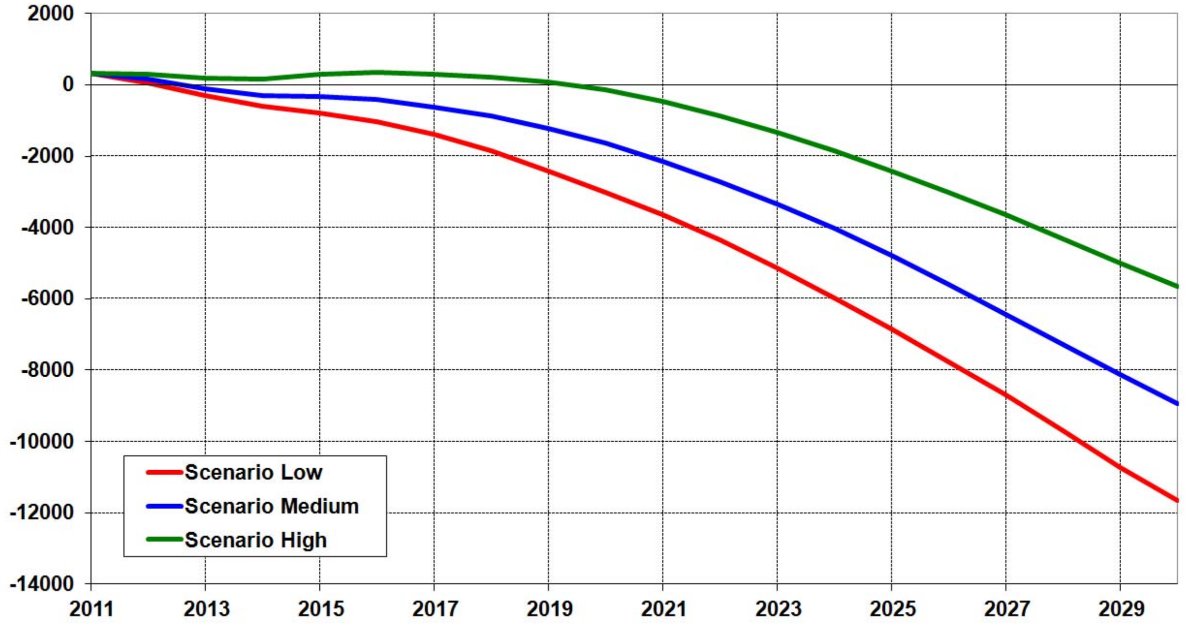
Diagram 1: Old-age dependency ratios



The diagram above shows the effect of different population trend scenarios on the old-age dependency ratio from the year 2010. The impact on the number of pension recipients is only identifiable up to 2030. Sizeable demographic groups reaching retirement age after 2030 should also be taken into account.

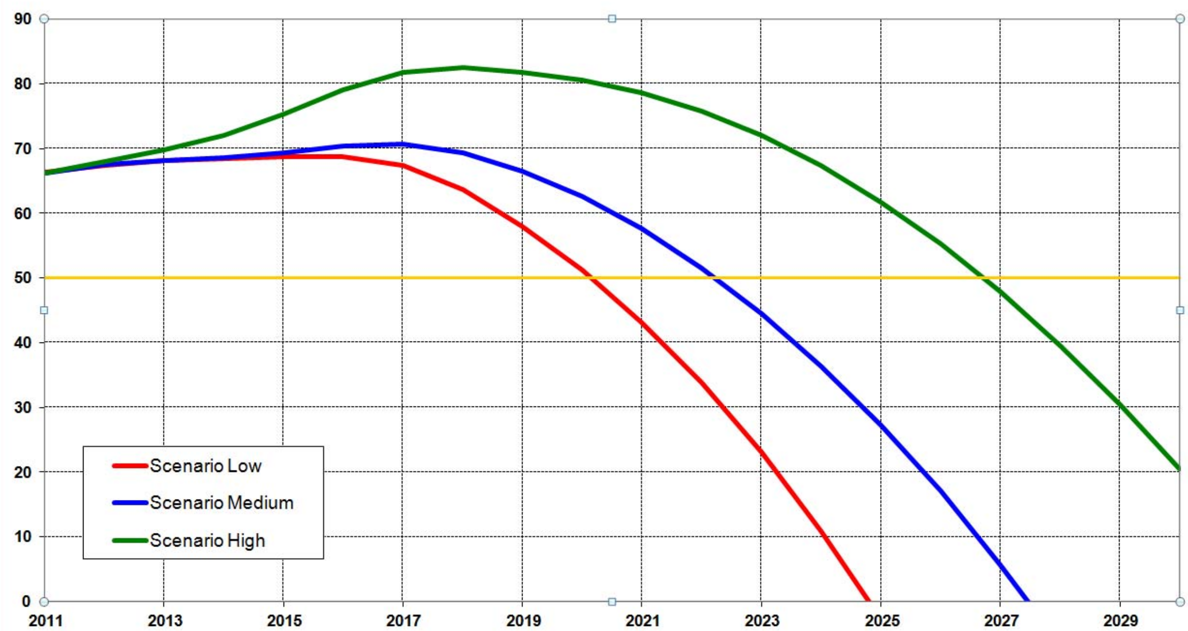
At present, the AVS fund is sufficiently capitalized to cover the initial net financial deficits resulting from the difference between annual income (excluding interest) and expenditure. In 2011, the AVS's CHF 39 billion in income outweighed its CHF 38 billion in total expenditure, representing a profit of CHF 1 billion. The separation between the AVS fund and the AI fund resulted in a non-repayable transfer of CHF 5 billion to the AI fund. In 2011, the AVS fund covered 105.5% of annual expenditure, thus exceeding the statutory requirement (Art. 107 para. 3 AVS). According to the AVS's financing scenarios, the AVS will be in deficit between 2013 and 2015. From 2015, investment income should be able to offset the deficit until around 2020, at which point the AVS's assets will need to be used to pay out pensions.

Diagram 2: The AVS's net finances; difference between income (excluding interest) and expenditure in CHF millions



In 2011, the AVS's capital amounted to CHF 40.1 billion, of which CHF 14.9 billion were AI debts. Whenever the AVS's available liquidity (i.e. without taking AI debts into account) falls under 50% of annual expenditure, a threshold is reached at which a rapid deterioration of the AVS's finances can be expected. The AVS's future liquidity depends, among other things, on the repayment of AI debts.

Diagram 3: Liquidity in the AVS fund, expressed as a percentage of the AVS's annual expenditure in accordance with applicable law

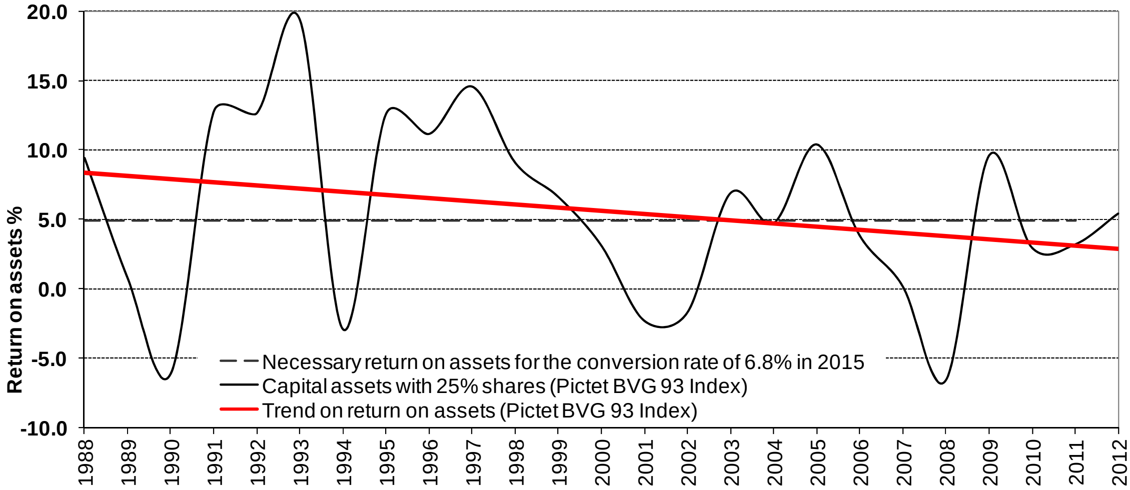


All the AVS's financing scenarios show that the additional financing requirement from 2020 can no longer be covered by the AVS in its current form. From 2020, new forms of financing will need to be used to fund benefits.

2.2.3. Financing outlook for occupational benefit plans

Occupational benefit plans have seen their average investment returns decreasing continually over the last 10 years. The interest rate on 10-year Confederation bonds has fallen from 3.8% in January 2000 to its current level of 0.6%. The average return on the Pictet Index 93, which has a 25% equity share, amounted to just 2.77% over the last 10 years. During the same period, the 6.8% conversion rate that applied following the first LPP revision equated to a return of 4.5 to 5%. The Pictet Index 93 reflects the investment portfolio of numerous provident institutions (pension funds).

Diagram 4: Investment returns



Pictet Index 93 reflects the investment policies of a majority of provident institutions and is therefore widely used and recognized in relation to occupational benefit plans. The diagram shows that, from 2001, provident institutions that invested their assets in accordance with this index generated lower revenues from their investment than would have been necessary with a LPP conversion rate of 6.8%.

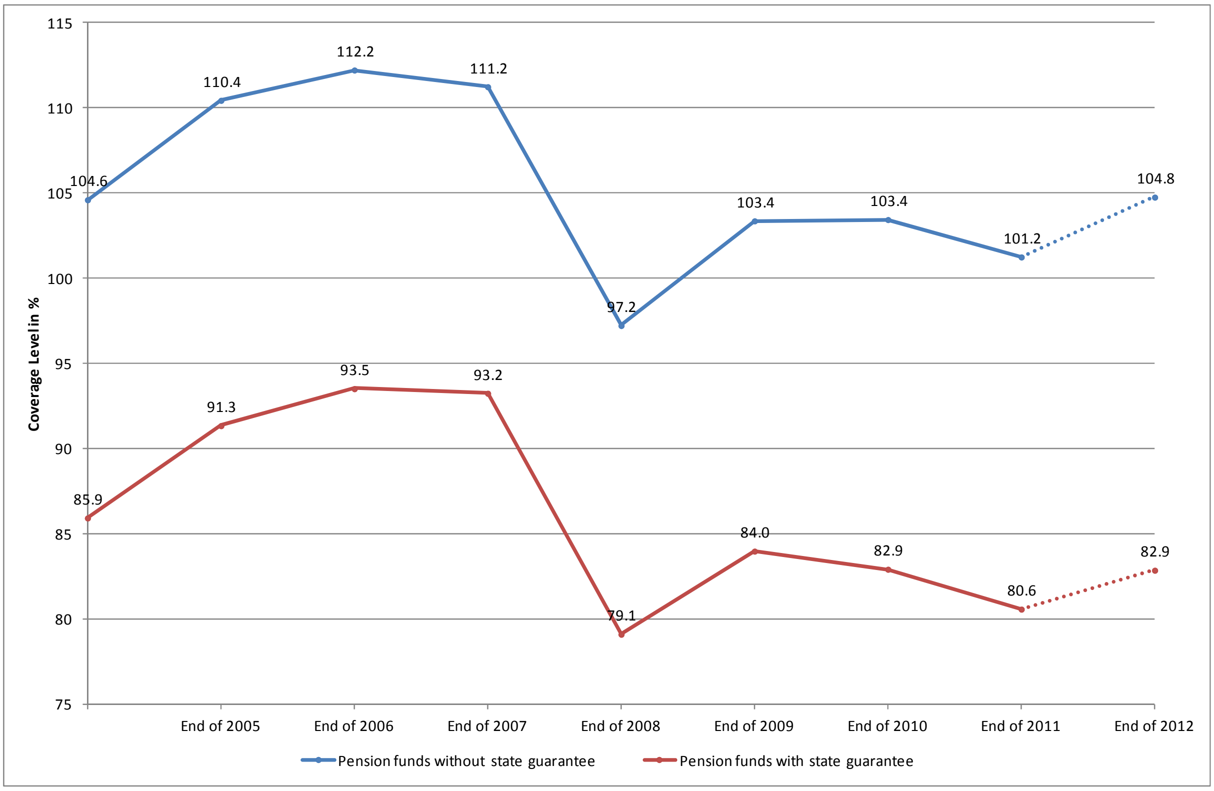
This situation is exacerbated by the continual rise in life expectancy, which in turn results in the actuarial reserve having to be spread over a longer period. With regard to occupational benefit plans, these circumstances mean that returns on assets must be used primarily to pay out interest on pension recipients' capital, thus resulting in a redistribution of funds to retirees at the expense of active pension fund members. The higher the share of actuarial reserves for pensions making up a provident institution's total benefits capital, the greater this imbalance.

Numerous provident institutions have posted retirement losses over the last 10 years as a result. The reason why this has not had a more negative impact on the stability of occupational benefit plans is that the minimum conversion rate only applies to the statutory minimum benefits. The majority of provident institutions also insure beyond the statutory minimum (extra-compulsory benefits); they merely maintain their statutory minimum reserve via a shadow account. Such provident institutions can reduce their conversion rate to below the statutory minimum conversion rate and make use of this option accordingly. However, the minimum conversion rate must be defined at a level that allows it to be used by provident institutions which only insure the compulsory part or barely above and beyond this.

The financial health of provident institutions is subject to considerable uncertainty. The degrees of coverage for registered provident institutions clearly show that not all schemes have returned to the state they were in before the financial crisis of 2008. The first nine months of 2012 saw a slight reversal in fortunes – in comparison with 2010 and 2011. Yet, despite coverage levels stabilizing, realized profits have generally still been insufficient to generate adequate fluctuation reserves.

Provident institutions therefore still risk incurring shortfalls in the short to medium term. At the end of September 2012, around 10% of registered provident institutions[5] without a state guarantee and some 60% of provident institutions underwritten by the state were showing shortfalls. The gross return for provident institutions amounted to around 6% between the end of 2011 and the end of September 2012, whereas 1.1% was the estimated return for 2011.

Diagram 5: Capital-weighted coverage levels



Source: 2004-2020: Pension Funds Statistics FSO, calculations of FSIO; from 2011, estimates FSIO

Another rise in coverage levels depends significantly on the medium to long-term performance of the financial markets. The debt crisis has heightened uncertainty in this regard, and the majority of provident institutions in future will have to negotiate risks without any fluctuation reserves. Despite the slight increase since the end of 2011, a further drop in provident institution coverage levels cannot be ruled out should the situation on the financial markets continue to deteriorate. The overall consensus is that the situation remains difficult, given that two-thirds of corporate provident institutions offered by the private sector have insufficient or non-existent fluctuation reserves. In other words, such provident institutions are no longer equipped to bear the brunt of another financial crisis should the financial markets continue to stagnate or even deteriorate.

2.2.4. AVS and AI supplementary benefits

Expenditure related to supplementary benefits is dependent both on internal AVS and AI factors (number and financial situation of persons receiving pensions) and external factors (health costs). The continual rise in costs over the past 10 years is mainly attributable to demographics and their impact on these two factors[6]. However, two recent legislative changes have also contributed to increased costs. Firstly, the maximum supplementary

[5] A "registered provident institution" is a pension fund that is recorded in the register for occupational benefit plans. In accordance with Art. 48 para. 1 LPP, provident institutions wanting to provide compulsory insurance must be entered in this register.
[6] Increase in the number of persons entitled to pensions under AVS/AI, and rise in institution-related costs.

benefit amount for persons living in institutions has risen as a result of national fiscal equalization (NFE)[7]. Secondly, the limit beyond which personal assets are considered has increased[8]. Demographic trends mean that the cost of supplementary benefits will continue to appreciate in future. This cost inflation will primarily affect the cantons because institution-related costs, which are financed solely by the cantons, are likely to rise the sharpest. Cost participation by the Confederation – aimed solely at safeguarding basic needs – will, however, follow the evolution of the population of retired persons.

[7] Before NFE came into effect, the supplementary benefit amount for persons living in institutions was limited to around CHF 32,000 per year. This limit no longer applies.

[8] As part of the new care-financing arrangement, which entered into force on 1 January 2011, the tax allowance on cash assets was increased by 50% to CHF 37,500 for single persons and to CHF 60,000 for married couples. In the case of one of the spouses living in an institution or in the case of a person who receives supplementary benefits also receiving a helplessness allowance, the allowance for owner-occupied properties was raised from CHF 112,500 to CHF 300,000.

2.3. Key guidelines

2.3.1. General objectives

According to Art. 111 of the Federal Constitution, the Confederation must "take measures to ensure adequate financial provision for the elderly, surviving spouses and children, and persons with disabilities". This provision shall be based on three pillars, namely the old-age, survivors' and invalidity insurance, occupational benefit plans and individual provident measures. In other words, the Federal Constitution applies the principle that the defined objectives should be achieved using all three pillars. While the AVS/AI should provide adequate coverage of living expenses as a basic insurance, the Federal Constitution stipulates that occupational benefit plans should guarantee an insured person's accustomed standard of living to an adequate extent[9]. It is expressly stated that a combination of the 1st and 2nd pillar shall be used to fulfill this joint objective. Since being definitively incorporated in the Federal Constitution in 2008 and becoming an essential part of the three-pillar system, the AVS and AI supplementary benefits have been used to fill pension gaps. They are the last piece in the jigsaw in terms of providing coverage of basic living expenses. From a constitutional point of view, occupational benefit plans, the AVS/AI and supplementary benefits are therefore closely linked to each other.

In accordance with the consistent interpretation of these provisions by the Federal Council, which were first formulated in 1972 to coincide with the introduction of the three-pillar system, an "accustomed standard of living" is viewed as being "satisfactorily maintained" if AVS/AI and occupational benefits together account for 60% of the insured person's most recent gross annual income, but no more than the appropriate maximum amount (a ceiling that relieves the Federal Insurance from having to guarantee the accustomed standard of living enjoyed by affluent individuals). It is this interpretation of the Federal Constitution that the Federal Council also applied in its Dispatch of 1 March 2000 on the 1st revision of the LPP[10] – an interpretation that also largely corresponds to Convention no. 128 of the International Labour Organization which was ratified by Switzerland. In addition, it should be noted that the occupational benefit plans are currently subject to a development phase. The constitutional objective for occupational benefit plans is likely to be achieved in full by around 2025.

Thanks to the success of the three-pillar system, we can conclude today that, in the large majority of cases, an uninterrupted professional career in Switzerland is generally sufficient to guarantee coverage of a pensioner's living expenses and ensure his or her accustomed standard of living. In terms of low incomes, the 60% rate representing the percentage of income is, however, inadequate for maintaining an insured person's accustomed standard of living. In certain low-income cases, the AVS/AI is only fully effective via the use of subsidies originating from supplementary benefits.

To ensure adequate social benefits, any reform of the pension system must continue to guarantee the existing system's benefits, particularly for people around the 60% threshold on which pension system is based. Interface and coherence between the 1st and 2nd pillar must therefore be maintained. Where necessary, supplementary benefits must continue to fill old-age benefit gaps. To achieve the desired effect, the reform measures must be able to guarantee the financial sustainability of our systems as well as adequately ensure pensioners' standard of living. This necessitates a holistic approach to pensions. There needs to be clarity with regard to social objectives and the type of social insurance required to fulfil these, and in terms of which financing sources (contributions, direct taxes, VAT) are to be used to fund which benefits. A holistic approach also involves defining how measures taken with regard to a specific insurance affect other social insurances and supplementary benefits, as well as ascertaining the adjustments that such measures demand of other social insurances. It should also take the impact on cantons and municipalities into account,

[9] Art. 112 para. 2 and Art.113 Federal Constitution.
[10] Federal Gazette 2000 2676.

ensuring that the reform of the pension system does not lead to the financial burden shifting from social insurances to social benefits at cantonal/municipal level.

2.3.2. The issue of retirement

2.3.2.1. Preliminary study conclusions

The studies carried out as part of our preparatory work in relation to demographics and financial issues confirm the hypotheses regarding future life expectancies and provide the following conclusions:

- The forecasts based on a macroeconomic model confirm the demographic scenarios and illustrate their impact on the AVS until 2060[11]. They also confirm that the problem of demographic ageing will be accentuated by the second babyboom generation reaching retirement age in the 2030s, and that this isolated phenomenon alone will result in an estimated financing gap of CHF 3 billion.
- Higher life expectancies do not apply equally to all socio-professional categories. Studies on varying life expectancies[12] confirm that people with lower levels of education, of whom most have lower incomes, live shorter lives on average[13]. This fact should be taken into particular account with respect to pension systems for population groups with low incomes.
- In international terms, Switzerland as a country has one of the highest employment rates for older workers. The employment rate has risen over recent years, but has not yet reached the ordinary retirement age ceiling.[14]
- On closer analysis, the theme of retirement[15] reveals certain contradictions between the future needs of the labour market and the employment of older workers. Although labour shortages are becoming apparent, the Swiss companies that were surveyed admitted that they would only recruit older workers at the last resort in order to fill their manpower gap. Companies are also not investing enough in the development and recruitment of older workers.

The analysis of the labour market as part of the preliminary studies also shows that there is a still a considerable time discrepancy between actual retirement age, i.e. the age at which people actually stop working (64.1 years for men, 62.6 years for women[16]), and the AVS-specified retirement age. Around 40% of people retire before and one-third continue to work after reaching the AVS retirement age. The latter group consists primarily of people who are self-employed (three-quarters), as well as those who work part-time or in specific positions. Despite older employees being willing to work longer provided their working conditions are good, companies appear to acting inconsistently when it comes to employing older members of the population. Nevertheless, companies do seem to be particularly interested in employing people in specific fields beyond the retirement age wherever knowledge and expertise needs to be passed on to younger generations. However, surveys carried out at companies and involving older workers have shown that both employers and employees are against a general rise in the retirement age. Instead, they would prefer the conditions for retirement to be made more flexible, enabling greater compatibility between employment and retirement.[17]

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[11] *Babyboom-Generation und AHV 2010-2060*, U. Müller, M. Eichler, Beiträge zur Sozialen Sicherheit 9/12, 2012.
[12] *Mortalité différentielle en Suisse 1990-2005*, P. Wanner, M. Lerch, Beiträge zur Sozialen Sicherheit 10/12, 2012.
[13] There is a difference in life expectancy of around two years between people lacking educational qualifications at post-secondary level and people who have had tertiary educations.
[14] The study's results are confirmed by the OECD's findings, which show that only Iceland, New Zealand, Sweden and Norway have a higher employment rate in the 55-to-64 age group than Switzerland (*OECD, Employment Outlook 2012*).
[15] *Altersrücktritt im Kontext der demographischen Entwicklung*, J.Trageser, S. Hammer, J. Fliedner, Beiträge zur Sozialen Sicherheit 11/12, 2012
[16] *Altersrücktritt im Kontext der demographischen Entwicklung* (Statistische Analysen) M. Kolly, Beiträge zur Sozialen Sicherheit 11/12, 2012.
[17] This information originates from the research report *Altersrücktritt im Kontext der demographischen Entwicklung*, op. cit.

2.3.2.2. Guidelines in relation to retirement

Due to the changing structure of the age pyramid and the financial outlook for pensions, rethinking the rule on retirement age would, on the face of it, appear to make sense. However, two other key aspects must be taken into account with regard to altering the retirement age: the realities of the labour market as well as the existing imbalances in terms of life expectancy and the opportunities to remain employed beyond a certain age. The above-mentioned trends in the labour market are the reason why circumspection is necessary when increasing the retirement age. Yet, they also justify making the conditions of retirement more flexible to ensure greater compatibility between employment and retirement.

With regard to retirement, emphasis should be placed on measures that help bring the actual retirement age closer to the AVS retirement age. At least in terms of the AVS, this approach would allow for an improvement in the level of wage-dependent financing. A relaxing of retirement conditions must allow for a closer interface between retirement and employment (flexibilization of retirement, partial retirement, gradual retirement).

To achieve greater all-round flexibility with regard to retirement, discontinuing use of the word "retirement" and referring instead to a "reference age" that is equal for men and women is the proposed course of action. The reference age is set at 65 years and gives rise to the full amount of pension benefits due under law (i.e. the pension amount without reductions or supplements). This reference age would of course apply under both the AVS and the 2nd pillar. Introducing a flexible retirement system for a specific age range would be the ultimate objective. Apart from the reference age, actuarial principles would determine the amount of benefits paid out.

The key elements can therefore be summarized as follows:

- Reference age of 65 in terms of the AVS and LPP
- Flexible retirement system for a specific age range in terms of the AVS and LPP, based on actuarial principles

The introduction of incentives is also proposed, be it in relation to the pension system (e.g. increased benefits in the event of extended employment) or recruitment (incentives for employers to develop recruitment policies favourable to older members of the workforce). To bring the actual retirement age as closely as possible up to the reference age, ways should also be explored to reduce the attractiveness of early retirement. Increasing the threshold of 58 as the earliest retirement age for occupational benefit plans represents an option in this regard. Nevertheless, doing so would result in restrictions to tax-privileged pre-financing of early retirement[18].

Once these measures have been implemented, the question of whether to increase the reference age based on the employment potential of older workers can be considered. If increasing the reference age did not result in redundant workers being absorbed by the labour market, all that would induce a transfer of financial charges across the social security system. In other words, what was meant as an attempt to solve a financing problem would actually end up creating greater social risks. Without any labour market absorption of older workers, an increase in the reference/retirement age would also fail to have the desired financing effect generated by rising salary contributions. The willingness of the labour market to take on older workers is prerequisite to any increase in the reference age.

[18] Socially justified exceptions should, however, continue to be accepted as reasons for early retirement, as is already the case (e.g. under welfare schemes).

Guidelines for reforming the retirement age under the 1st and 2nd pillar:

- Harmonize reference age for men and women at 65 years (AVS and LPP)
- Flexibilize AVS and LPP retirement provisions in a coordinated and actuarially appropriate manner
- Incentives for continued employment until the reference age and beyond
- Reduce the attractiveness of early retirement; in particular, increase the threshold of 58 as the earliest retirement age for occupational benefit plans

2.3.3. Maintaining the level of benefits and adjusting the actuarial parameters

2.3.3.1. Occupational benefit plans

The LPP came into force on January 1, 1985. It provides insurance benefits in line with the statutory minimum to all employees who earn a specific income. The LPP is still in the development phase. It will not be until 2025 that the first generation of LPP retirees is entitled to their statutory minimum benefits.

As they stand today, occupational benefit plans, together with the benefits of the 1st pillar, do not yet reach the benefit target stipulated in the Federal Constitution. Actuarial parameters need altering in line with higher life expectancy and the changing interest rate environment, but such adjustments must not lead to a reduction in the level of benefits **under the LPP minimum provision**.

2.3.3.2. Significance of the conversion rate

Occupational benefits are determined by the conversion rate that is used to convert an insured person's retirement assets into an annual occupational pension.

The conversion rate depends on two factors: the selected actuarial basis (statistical probability data related to life expectancy, widowhood, marriage, etc.) of a provident institution and the technical interest rate (interest rate used for calculating the actuarial reserves).

Provident institutions that also insure the extra-compulsory benefits can define the conversion rate based on their chosen actuarial parameters. The LPP contains statutory regulations that govern the minimum conversion rate. However, the LPP minimum conversion rate is also subject to actuarial parameters.

As has already been mentioned, occupational benefit plans are in a difficult financial state as a result of falling investment returns and higher life expectancy. The minimum conversion rate for the compulsory portion must therefore be cut to an appropriate level. Benefits in line with the LPP minimum provision, together with AVS/AI pensions, meet the pension rate objective – on which the three-pillar concept is based – of 60% of the insured person's most recent income. Therefore, reducing the conversion rate to a technically adequate level must not result in a reduction in pensions under the LPP minimum provision. This is all the more important because, unlike AVS pensions, occupational pensions do not feature any entitlement to cost-of-living adjustments[19].

[19] Old-age benefits must be altered in line with inflation based on the financial resources of the provident institution in question.

2.3.3.3. Prerequisites for a conversion rate adjustment to command majority backing

Any new proposal for adjusting the conversion rate must take into account the reasons why the adjustment of the LPP conversion rate was rejected so emphatically in the referendum of 7 March 2010. The most important reasons were as follows:

- Unlike in the first LPP revision, no measures had been drawn up to maintain the level of benefits. A reduction of the LPP conversion rate would therefore have resulted in a decrease in LPP benefits.
- The draft proposal was attacked on the grounds that the administrative costs and, in particular, the costs of asset management were too high.
- As a result of the lack of transparency on the part of insurers and what in many circles was viewed as the unsatisfactory distribution of profits to insured persons and shareholders, the proposed reduction was regarded as unfair.

Since the no-vote in 2010, nothing has fundamentally changed with regard to the prevailing circumstances in which a reduction in the conversion rate would take place. A new draft must therefore take into account the criticisms that were expressed back then. For it to be a success, both institutional and social policy prerequisites need to be met. Compensatory measures are necessary, particularly for the intermediate generation; as are institutional measures.

Maintaining the level of benefits

Compensatory measures are necessary to prevent a cut in the conversion rate leading to a reduction in the level of benefits in the case of low and medium incomes. Focus should be on achieving the objective of ensuring a guaranteed level of LPP benefits. Additional old-age credits are therefore necessary. These can be generated by beginning the savings process at an early stage, through higher contributions or through a reduction in the coordination deduction.

The amount of additional funds needed to maintain the level of benefits depends on the the extent to which the conversion rate is adjusted. To maintain the level of benefits in the event of the conversion rate being reduced to 5.8% for example, an additional CHF 3.9 billion in contribution income would, according to preliminary estimates, be necessary to enable an adequate increase in retirement assets. If the conversion rate changed to 6.4%, as was recommended in the report regarding the future of the 2nd pillar, an additional CHF 1.5 billion would be necessary. After an adjustment to 6.4%, however, another review of the conversion rate would be necessary not long after. The aforementioned amounts are indicative of the expected costs within the LPP framework. However, the *actual* financing requirement is likely to be much lower; it would amount to CHF 1.8 billion and CHF 680 billion respectively in the above-mentioned examples. This reduction is attributable to the impact on the extra-compulsory portion of the 2nd pillar. In all-inclusive provident institutions, the conversion rate is only applied via a shadow account to the portion subject to compulsory insurance. The increase in retirement assets is likely to be fully or partially balanced via the extra-compulsory portion.

In the absence of any compensatory measures, the level of benefits in line with the statutory minimum would be cut by 6% if the conversion rate was reduced from 6.8% to 6.4%, or by 15% if the rate was brought down to 5.8%.

Measures for the intermediate generation

To prevent the level of benefits from falling as a result of an adjustment to the conversion rate, targeted compensatory measures are necessary for people who, due to their age, are no longer able to bring their LPP retirement assets up to the required level by boosting their contributions. Special transitional arrangements are necessary for this particular group of the population and – the shorter the period in which the conversion rate is reduced – must be all the more effective. In view of the retirement losses of recent years, a speedy reduction in the conversion rate is preferable, albeit one which that would trigger a correspondingly higher offsetting requirement.

To enable compensatory measures to take effect as quickly as possible, contribution-financed measures need to be agreed. Two options are possible in this regard – the first involving the Guarantee Fund, the second entailing the AVS. In the case of the Guarantee Fund, a capital supplement must be granted to the first generations that are affected by a reduction in the conversion rate and that only have benefits at their disposal in line with the LPP minimum provision, thus allowing those affected to increase their retirement assets and, consequently, their pensions. The AVS-based solution targets the same objective, albeit with the AVS pension increased accordingly for the same category of persons. Persons who receive their benefits in form of capital are not affected by a reduction in the conversion rate and are therefore not entitled to social compensation measures of this nature.

The cost of temporary compensatory measures depends on the number of recipients and the adjustment frequency. Initial estimates put the initial annual costs at around CHF 40 million in the case of a 6.4% conversion rate, or at CHF 130 million in the case of a 5.8% conversion rate, provided the circle of recipients is limited to those who are insured via pension funds with benefit plans in line with the LPP minimum provision. Depending on the option chosen, these costs would initially rise and then decrease again as part of a secondary phase until the final intermediate generation year group reached retirement age.

Institutional measures

Institutional measures necessitate adjustments to insurance supervision legislation. The FDHA and the Federal Department of Finance (FDF) have therefore been instructed to submit proposals to the Federal Council for improvements in the following areas:

- Expand supervision over life insurers in relation to occupational benefit plans

  When approving insurers' rates, FINMA's remit should not be limited to merely assessing the impact on insurer solvency or the existence of improper tariff provisions. FINMA's supervisory role should instead focus on evaluating whether the interests of those insured are actually being safeguarded. In other words, FINMA should, in view of the special characteristics of occupational benefit plans, also incorporate aspects related to protecting insured persons into its supervisory role. In particular, supervision must focus on the adequacy of risk premiums in relation to risk benefits, the extent of administrative costs, the legitimacy of contributions to administrative costs, and the transparent definition of criteria for profit participation and calculation thereof.

- Improve transparency

  Improvements are necessary in disclosing provisions and identifying administrative costs. Risk premiums must be plausibly justified.

- Improve regulations on profit participation

  The statutory provisions need adjusting to establish a fair balance between insured persons and shareholders as risk capital providers. The current profit participation system requires a thorough review.

- Eliminate false incentives in the area of insurance brokerage

  The statutory provisions governing pension and insurance law need harmonizing to prevent insurance law from being used to by-pass the restriction stipulated in pension law on accepting pecuniary advantages.

Guidelines for reforms related to occupational benefit plans:

- Adjust the LPP minimum conversion rate to take account of higher life expectancy and changes in the interest rate environment
- Compensatory measures necessary to maintain level of benefits, including for the intermediate generation
- Evaluate institutional measures for the purpose of expanding FINMA supervisory control to ensure effective protection of insured persons, improve transparency on the part of insurers and achieve a more balanced distribution of profits among insured persons and shareholders.

2.3.4. Financial consolidation of the AVS

The financial outlook for the AVS points to significant financing deficits by around 2020, which should increase gradually until 2030. According to the medium financing scenario and provided the financing system remains unchanged, the AVS's additional financial requirement is likely to reach CHF 8.9 billion by 2030. This figure could rise or fall if the parameters that affect the AVS's financing change considerably.

Given that the pressure exerted by demographic trends on the AVS's financing has not yet reached acute levels, rigorous restructuring measures do not appear necessary in the current situation. However, timely measures within the medium term to consolidate the AVS's finances are justified in view of the extent of the expected deficit. In these circumstances, proposing an overly one-sided reform, entailing either a sharp cut in benefits or a significant increase in the reference age, would represent a risky move at present. A circumspect approach combining more than one solution is preferable.

Harmonizing the reference age at 65 while also introducing measures to bring the actual retirement age closer to the reference age will help to achieve a partial closing of the AVS's expected financing gap. Yet, this alone is not enough to ensure long-term financial equilibrium. To cover the AVS's shortfall, additional financing sources must still be explored. In view of the current level of AVS benefits and the above-mentioned aim of guaranteeing an insured person's accustomed standard of living, any general reduction in old-age benefits is categorically out of the question. Nevertheless, by implementing targeted and – in view of social trends – justifiable modifications, it is possible to curb expenditure and bolster the financial resources originating from insurance contributions. A catalogue of measures documenting benefits and contributions must be drawn up in order achieve realistic savings and additional income while paying due regard to the following principles: no changes may result in economic hardship and the social protection of weaker members of society must be ensured. With this in mind, the FDHA will look again in particular at benefits for surviving dependants, the rules governing contributions from self-employed persons, and contribution privileges.

To cover the remaining financing requirement, the search for new financing sources will be expanded. Since an increase in labour costs would only exacerbate the situation for employees and have a detrimental impact on wages, the FDHA currently favours VAT-based financing. The advantage of using VAT as a source of financing is that it encourages solidarity across all the generations – including retirees. VAT-based financing can, however, be combined with an increase in salary contributions.

Guidelines for sustainable financing of the AVS:

- Evaluate the necessity of adjusting benefits and contributions in line with economic and social changes
- Evaluate additional financing

2.3.5. Intervention mechanism in the AVS

The AVS should have a regulatory financial instrument at its disposal that can be used effectively within precisely defined legal parameters – something which the Luginbühl Motion[20] has already called for. The study carried out as part of our preparatory work[21] reveals that the AVS system and Switzerland's system of direct democracy are unsuitable for a fully self-regulated intervention mechanism (similar to the ones applied in some OCED countries). An intervention mechanism that is compatible with our system should act more as a warning flag within the political process and, where appropriate, facilitate targeted and limited automatic measures. In other words, an AVS intervention mechanism should neither compromise the legislator's role in determining the AVS's financing mechanisms nor limit the lawmaker's ultimate responsibility for taking emergency measures.

The intervention mechanism suggested in AI revision 6b fulfils the above-mentioned principles. If the first intervention level is reached, the Federal Council must propose restructuring measures; if the second intervention level is reached, automatic measures are triggered relating to both the pension amount and the salary contribution rate. However, the responsible National Council commission has put the automatic nature of this process into question and suggested forgoing the second intervention level.

The key points specified in AI revision 6b could serve as a model for the AVS. Following fierce parliament debates regarding the intervention arrangements put forward in the 11th AHV revision, and owing to the sensitivity of the issue, the risk of a consensus not being reached on an automatic form of regulation cannot be underestimated. For this reason, further parliamentary consultation is necessary regarding the specifications of the AI revision in order to attain a greater appreciation of the actual procedures required for the AVS.

Commenting on a motion[22] that demanded the speedy introduction of a fiscal rule in relation to the AVS, the Federal Council stated that it would decide how to approach this issue once the guidelines for reforming the pension system are accepted. Since the need for action is not urgent in view of the AVS's finances, the FDHA believes that no decision is necessary yet on whether to fast-track the introduction of a fiscal rule and whether the issue should be treated separately or as part of the overall draft on reforming the pension system. Suitable proposals should be incorporated in the overall draft instead. The FDHA will therefore submit a report this summer on the intervention mechanism and possible courses of action.

The Confederation's contribution to the AVS currently accounts for 19.55% of the AVS's overall expenditure. This percentage will increase sharply as a result of demographic trends. It is therefore necessary to ascertain whether the Confederation's contribution should be decoupled from expenditure and linked to VAT earnings instead.

[20] Motion 11.3113 *Introduction of fiscal rules in relation to the AVS and AI*
[21] *Steuerungsmechanismen in der AHV*, L-P. Feld, C. A. Schaltegger, Beiträge zur Sozialen Sicherheit 7/12, 2012
[22] Motion 12.3553 *Quick introduction of AVS debt cap*

Guidelines on introducing an AVS intervention mechanism

- Devise an intervention mechanism, based on the key points of AI revision 6b and in accordance with specific AVS intervention thresholds
- Simultaneous proposals concerning reference age harmonization and an intervention mechanism
- Evaluate the possibility of linking the federal contribution to VAT earnings

2.3.6. AVS and AI supplementary benefits

In terms of benefits that are supplementary to the AVS and AI, two different problems need to be dealt with. In the short term, targeted improvements are necessary to ensure adequate coverage of pensioners' living expenses. In particular, imputable maximum rents – which have not been adjusted for about 10 years – need to be index-based as quickly as possible and adjusted in line with actual costs according to the specifications of the motion[23] of the Committee of Social Security and Health of the National Council which was recently approved by parliament. To achieve this objective, the FDHA aims to submit a draft for consultation to the Federal Council during the course of 2013.

In the medium term, the sharp increase in supplementary benefit expenditure that is closely linked to health costs means that strategies need to be developed in consultation with the cantons to achieve better cost control in this area. Although the use of supplementary benefits to finance care costs has proven effective, the appropriateness of a care insurance scheme to cover care-related costs at institutions will also have to be assessed as a possible alternative to the current system of financing. In response to a number of recent parliamentary motions, the applicable regulations will also require scrutiny as part of a detailed report offering a range of solutions[24]. The introduction of corrective measures will also be evaluated, via which specific practices – such as early use of pension capital provided by the 2nd pillar – could be approved.

[23] According to Motion 11.4034. (*Imputable maximum rents in relation to AVS and AI supplementary benefits*), the possible financial impact of rent indexation should not be allowed to negatively affect the Confederation's contribution to covering institution-related costs.
[24] Postulate 12.3602 *Reform of AVS/AI supplementary benefits*; Postulate 12.3673 *AVS/AI supplementary benefits*; *Outlook 2020* and Postulate 12.3677 *The need for clarification in relation to AVS/AI supplementary benefits*