Focus 01/19:
Retirement pensions

Gaps in the public pension system lend growing importance to private pension schemes

More than a year has passed since Swiss referendum voters rejected plans for an overhaul of the country's public old-age pension system, originally scheduled to take effect in 2020. The Swiss public pension system has thus not undergone any significant reform for over 20 years now. During that time, demographic changes and an extended period of unusually low interest rates have together given rise to glaring deficiencies in the existing system. The fact that the pension system is facing an acute crisis is widely acknowledged. In the absence of swift measures to remedy it, however, the situation will only continue to deteriorate.
The Swiss pension system is based on what is called the "Three Pillar Principle". The first pillar is the public social security system which provides for old-age and survivors' insurance (OASI) intended to cover minimum basic needs following retirement. It is financed through a pay-as-you-go system, under which pension benefits paid out are financed by incoming contributions. The second pillar is occupational pension plans, which rely on capital accumulation as a means of providing retirement income. Employees who are members of a pension scheme pay a part of their salaries into an interest-bearing savings fund, from which they later draw benefits in the form of a regular pension and/or a lump-sum payment. The third pillar is private pension plans. These provide a means for accumulating retirement savings in a way that also offers substantial tax advantages.

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The rise in life expectancy and, with it, the possibility of enjoying retirement for more and more years is certainly a positive development. Nevertheless, it also creates a major challenge for our pension system. And it is becoming increasingly clear that unless measures are soon taken to deal with this new situation, future generations will pay the price.

What are the main reasons for the crisis in our pension system?
The first problem, of course, is the ageing of the population. In 1948, when social security in the form of old-age insurance was first introduced in Switzerland, the life expectancy for men aged 65 was 12.4 years. Since then, that figure has risen to approximately 19 years. For women aged 65, life expectancy has risen from 14 years in 1948 to 22 years today. Those additional years must be paid for. Moreover, people who were born during the so-called baby boom, when birth rates were exceptionally high, are now entering retirement age. This is clearly reflected by the rising old-age dependency ratio, which represents the population share of people of retirement age – 64 for women and 65 for men – as compared to that of the working population (from age 20 to 64/65). The ratio currently stands at 30%, with a strong upward trend. Over the next 20 to 30 years it is expected to rise to 50%, which means that two members of the work force will be needed to pay for a single pensioner – unless something is done in the meantime[1].

A second problem is the steadily decline of interest rates on the financial markets. This downward trend has continued over decades now, making it increasingly difficult for pension funds to meet performance expectations. The financial markets have traditionally been seen as the “third contributor” – in addition to employers and employees – to occupational pension funds. As yields continue to decline, however, those funds now find themselves in an ever worsening predicament, forcing them to accept higher and higher levels of risk. With interest rates now in negative territory, meeting even the most modest performance targets has become virtually impossible by relying only low-risk investments. The gap has been partially bridged by lowering both the technical interest and the conversion rate. Those rates are still too high, however, and a redistribution of income from the work force to the retired is already taking place. This situation is untenable, as it contravenes the underlying principle of inter-generational solidarity.

Thirdly, in recent years there has been a major shift in the way people live and work. The trend is towards more part-time employment, sometimes combined with self-employment. This leads to a certain restriction of opportunities for joining pension schemes which, in turn, also limits the possibilities for accumulating retirement savings.

Women live longer – and best when they are financially independent

Much has already been written about the pay gap between working men and women – but how do things look after retirement? According to a study published by the Bern University of Applied Sciences in December 2016, the gender pension gap in Switzerland now stands at 37% and is thus higher than the current gender wage gap.
It is true that many companies have improved conditions for part-time employees. At the same time, however, it is still mainly women who hold part-time positions – sometimes more than one at the

[1] Source of statistical data: Peter Morf, Finanz und Wirtschaft, „Einseitiger Versuch zur Sanierung der AHV“, 02.07.2018

same time – and thus, inevitably, also have lower incomes. Where pensions are concerned, there are two factors that play a decisive role in connection with part-time employment and mini-jobs in Switzerland. The first is the entry threshold, the second the so-called “coordination deduction”. As of 2019, the entry threshold for occupational pension plans is set at CHF 21,330. Employees who earn that amount or more must be enrolled by their employer in the company’s occupational pension plan. For part-time employees who earn enough to overcome this first hurdle, however, the coordination deduction then comes into play. Pension funds are permitted to apply that deduction (CHF 24,885 as of 2019) to the employee’s gross salary and are required to insure only the portion of the salary which is in excess of that amount. The major disadvantage connected with this deduction stems from the fact that it does not have to be adjusted proportionally for part-time employment as a percentage of full-time employment.

An additional disadvantage for those who hold more than one part-time job is that each employer is entitled to deduct the full amount. This substantially reduces the potential for accumulating retirement savings with the help of employer contributions. Fortunately, however, there do exist pension plans that are more welcoming towards part-time employees and voluntarily lower the entry threshold and/or adjust the coordination deduction in keeping with the percentage of full-time hours the employee works. Again, however, this is entirely voluntary on the part of the pension funds, and woman, in particular, would be well-advised to inform themselves in detail as to the conditions attaching to any occupational pension plan they join. An additional difficulty for women in accumulating retirement savings is that fact that their career paths are often more irregular than those of men – most commonly as a side-effect of maternity interruptions.

The challenges are thus numerous. But this is true not only for women. The new employment models currently emerging and efforts to improve the life-work balance will have consequences for everyone. These are issues that the all members of the younger generation will have to come to terms with, now and in the future.

Self-responsibility plays an ever-greater role

The steady decline in pension benefits promised by the system means that, in future, retirement savers will need to take a much closer look at their own individual occupational and private pension plans. In addition to occupational pension plan contributions, every working person in Switzerland is entitled to set aside a certain sum of money as tax-deductible savings in a separate “third pillar account”. For 2019, the maximum deduction for members of a pension fund has been set at CHF 6,826; for non-members, at CHF 34,128. Despite the low yields on third pillar savings accounts, only a small minority (some 23%)[2] of such account holders have invested that capital in securities. Savers are thus exploiting the potential for long-term wealth building through stocks and other market investments only to a very limited extent. And this despite the fact that, objectively speaking, adopting a long-term horizon is by far the more rational approach to investment. The reason for this reticence is a high degree of risk aversion where retirement savings are concerned. This is entirely understandable, and even made good sense in the past, when interest rates made it possible to earn attractive yields with little or no risk. Unfortunately, however, those days are gone, and it would

[2] Source: Verein Vorsorge Schweiz, Study 3a savings from Credit Suisse 2017, P.15

be wise for retirement savers to begin facing the new realities. The current era of low interest rates is likely to continue for some time. Under these conditions, long-term accumulation of capital is possible only through investments in securities, primarily stocks. For that, however, a certain level of risk – resulting from the inherent volatility of financial markets – must be accepted.

In the absence of reforms to the pension system at the broader political level there will be an increasing need for savers to take on a more active role in optimising their retirement planning at the individual level. The incentives for taking fuller advantage of the opportunities for tax-deductible, long-term capital accumulation are thus only likely to increase. And the sooner one begins, the better!