Life insurers and occupational pensions

I. Summary

The Swiss social insurance system is essentially based on three pillars: AHV (old age and survivors' insurance), occupational old age, survivors', and invalidity pensions (Pension Law), and the third pillar. This three-pillar concept has been enshrined in the Federal Constitution since 1972.

Pension funds have existed for over 100 years. As long as occupational pensions were voluntary, only those employees enjoyed protection whose employers had their own pension fund. This changed in 1985: The mandatory coverage of the Pension Law covers all employees with an income of at least 19,350 Swiss francs (as of 2005).

The pension systems of employers without their own pension funds are affiliated with collective institutions for occupational pensions, pension schemes under public law, large autonomous pension funds, or pension scheme associations. These are all subject to the Pension Law and are under the supervision of the Federal Social Insurance Office (FSIO). Private life insurance institutions providing reinsurance or full coverage for collective schemes or autonomous pension funds are under the supervision of FOPI.

Investments for occupational pensions total approximately 600 thousand million francs in Switzerland. Of these, 120 thousand million are managed by life insurers – on behalf of the reinsured pension schemes.

Private life insurers differ in several points from the pension schemes. For instance, with the objective of achieving high security for the policyholders and in addition to their technical reserves, they must provide backing for

- gaps in coverage for pension conversion rates
- the expected improvement of mortality, and
- equalization of non-linked fluctuations on the asset and liability side,

as well as own funds in the form of equity capital and reserves indexed to their business volume. By continuously monitoring changes in equity capital and reserves, measures can be taken in a timely manner, so that no shortages of coverage have occurred in the case of life insurers, in contrast to pension schemes. Life insurers must at all times cover at least 100% of their obligations, which must be documented periodically (also during the fiscal year) to the insurance supervision authority (FOPI) under the heading "safety fund"[1]. As part of the first Pension Law revision, the legislative power has adopted new transparency requirements for occupational pensions. These provisions entered into force on 1 April 2004 and are also part of the new Insurance Supervision Law (ISL).

[1] With the entry into force of the new ISL, the safety fund is termed "bound assets".

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II. The social insurance system in Switzerland

The Swiss social insurance system is essentially based on three pillars: AHV (old age and survivors' insurance), occupational old age, survivors', and invalidity pensions (Pension Law), and the third pillar. This three-pillar concept has been enshrined in the Federal Constitution since 1972.

- AHV was created in 1948. Together with Invalidity Insurance, it covers the basic needs of the insured persons.
- Occupational pension schemes constitute the second pillar. The first of these schemes have already existed for over 100 years. But only with the Federal Law on Occupational Old Age, Survivors' and Invalidity Pensions (Pension Law), which entered into force on 1 January 1985, did the legislative power introduce a guaranteed minimum pension – mandatory coverage. Together with the first pillar, the performance target is to achieve a retirement income of about 60% of the last salary – a goal that is met in practice, but not laid down in figures in the Federal Constitution.
- The third pillar consists of a personal savings plan, aimed at increasing retirement income according to personal needs and desires. It is voluntary and, in contrast to regular savings, subject to tax advantages.

III. The second pillar

1. Autonomous pension funds and collective institutions

Pension funds have existed for over 100 years. Notably the machine industry instituted such schemes. As long as occupational pensions were voluntary, only those employees enjoyed protection whose employers had their own pension fund. This changed in 1985: The mandatory coverage of the Pension Law covers all employees with an income of at least 19,350 Swiss francs (as of 2005).

The pension systems of employers without their own pension funds can affiliate themselves with collective occupational pension schemes. These collective schemes include backup schemes, pension scheme associations, and collective institutions. There are autonomous collective institutions and those run by private life insurers. The collective schemes are subject to the Pension Law and are under the supervision of the Federal Social Insurance Office (FSIO).

The collective institutions of the private life insurers only have limited assets of their own. Normally, they offer the pension systems full coverage of all savings and risk benefits, and the private life insurers assume all relevant risks. In particular, the life insurer guarantees payment of the minimum interest on the old age credit balance subject to mandatory Pension Law coverage, and it converts this balance into guaranteed pensions according to the pension conversion rate specified by the Pension Law once retirement age is reached. The capital investments remain with the insurer and are invested in accordance with the provisions of the Insurance Supervision Law.

Since, as a rule, the collective institutions established by the private life insurers have transferred their risks fully to the life insurer, they have so far primarily been accorded administrative responsibilities: They accept contributions from the affiliated pension systems and pass them on to the insurer; conversely, they receive benefits and capital bonuses owed by the insurer and pass them on to the pension systems in accordance with the provisions of the affiliation contracts. The private life insurers managing these assets are subject to FOPI supervision.

2. Differences between private life insurers and pension funds

Investments for occupational pensions total approximately 600 thousand million francs in Switzerland. Of these, 120 thousand million are managed by life insurers – on behalf of the reinsured pension schemes. Private life insurers differ from pension funds in several essential points:

- In addition to technical reserves, private life insurers must demonstrate own funds in the form of equity capital and reserves, indexed to their business volume (article 9 of the ISL). Such own funds requirements do not apply to pension funds and collective institutions. By continuously monitoring the fulfilment of own funds requirements for private life insurers, timely measures can be taken in the event of undesired developments, so that insufficient coverage can be prevented in the case of life insurers, in contrast to pension schemes. This means that FOPI already takes corrective measures when the own funds of a life insurer fall below a certain threshold. Currently, this threshold is calculated according to

predetermined requirements. In the future, it will be estimated and determined even more precisely according to a risk-based approach. This ensures that strict protective measures benefiting the policyholders are initiated long before a life insurer's coverage becomes insufficient.

- Private life insurers are in competition with each other; their insurance pool is not bound, as is normally the case for pension funds.
- The collective institutions founded and operated by life insurers primarily cover the pension systems of small and very small businesses. In comparison with autonomous pension funds, these collective institutions have disproportionately high administrative costs (e.g., because of frequent employee changes) in relation to the contributions and premiums. Moreover, the risk development of their invalidity insurance is often poorer. These additional costs must be compensated in part through returns on capital.

3. Transparency requirements

As part of the first Pension Law revision, the legislative power has adopted new transparency requirements for occupational pensions. These provisions entered into force on 1 April 2004 and are likewise part of the new Insurance Supervision Law (ISL), so they also affect life insurers.

The new transparency provisions have been realized through the incorporation of article 6(a) into the existing Life Insurance Law. In addition, further transparency provisions expressly included in the Pension Law are aimed at private life insurers that conclude insurance contracts for occupational pensions: article 68, paragraphs 3 and 4, and article 68(a).

The three main thrusts of the transparency requirements are:

- a separate safety fund for occupational pensions;
- starting in the 2005 fiscal year, submission of annual business accounts for occupational pensions, containing in particular a compilation of the administrative and sales costs;
- issuing of rules to determine and distribute capital bonuses and introduction of a minimum dividend payout rate for occupational pension insurance contracts subject to capital bonuses.

4. Calculation of the minimum rate

The starting point for calculating the minimum rate is the technical unbundling of the business accounts in the area of occupational pensions. The capital bonuses determined by this technical unbundling are transferred into a capital bonus fund. Dividends are only paid out of this capital bonus fund. The division of the capital bonus process into a calculation phase and a distribution phase achieves the highest possible transparency, ensuring optimal supervision by the supervision authority.

Generally speaking, there are two principles according to which the minimum rate of 90% is calculated: earnings-based and profit-based.

a) Earnings-based calculation

Earnings-based means that the total payments to the policyholders must at least reach the amount of the minimum share of the total earnings. This means that the insurer receives at most 10% of the total earnings. The remaining 90% are paid out to the policyholders in the form of insurance benefits, increases in the actuarial reserves for the benefit of the policyholders, actual running expenses, and capital bonuses.

As a rule, the minimum rate is calculated on the basis of earnings. This distribution is used in about 90% of cases.

b) Profit-based calculation

At the same time, the law provides for a special profit-based rule:

Profit-based distribution provides that the policyholders receive 90% of the profits and the insurers receive 10%. This distribution is used when the yield of the insurer is at least 6% (assigned capital yield of 6% of the assigned capital investments) and the minimum interest rate is at least 4% – i.e., very good conditions from the perspective of the insurer.

c) Special cases

In addition, the following are distinguished:

- contracts subject to the minimum rate, and
- contracts exempt from the minimum rate.

Contracts are exempt in which the policyholder (i.e., the pension schemes) bear the investment risk themselves. The capital investments under these contracts are then considered separately. These contracts are exempt from the minimum rate, since the policyholder in question both

bears the entire investment risk and receives the entire earnings.

d) The legal foundations
In 2004, business accounts need not yet be compiled, but the minimum rate must be complied with. The implementing regulations of FOPI for 2004 are provided in (provisional) circulars and codes of practice. The statement of the figures for 2005 is already governed by the new Supervision Ordinance. The mechanism is specified in article 191 of the Supervision Ordinance.

In “normal years”, i.e. when the earnings-based calculation is used, this differentiated mechanism ensures that the insurer can compensate for years with negative operating results (i.e., losses) in years with positive operating results. If the operating results in a given year are strongly positive, the profit-based method applies and ensures that the operating results are not distributed to the insurer in a one-sided manner.

5. Protection of the interests of the policyholder
To secure the obligations vis-à-vis the policyholders, the private life insurers domiciled in Switzerland must establish a safety fund, the size of which is primarily determined by the total of the actuarial reserves. Assets of this amount are separated out from the rest of the assets and listed in a separate “safety fund register” of the company. The safety fund assets are kept physically separate. The safety fund primarily consists of bonds, real estate, mortgages, and stock, complying with provisions concerning the maximum share of individual investments. As part of the transparency requirements, a special safety fund for occupational pensions is separated out.

a) Threat of insolvency
A life insurer may not simply go bankrupt. Before a bankruptcy can occur, a whole series of corrective measures are exhausted. For instance, FOPI may order that the life insurer in question may not conclude any new contracts. This blocks the balance on the liabilities side. If this still does not prevent insolvency, FOPI may order that the portfolio in question be transferred from the affected company to a different insurer, so that the portfolio can be continued without disadvantages for the policyholders. If the circumstances so require, FOPI may even enforce the relinquishment of a portfolio, but it may not oblige a new insurance company to accept it.

b) Bankruptcy of a life insurer
If the worst case arises and a life insurer goes bankrupt, the holders of life insurance policies enjoy privileged protection. This protection is covered by the safety fund. If bankruptcy occurs, the policyholders have a privileged right to these assets. It does not matter in this regard whether the life insurances have one-time or periodic premiums or whether they are capital or annuity insurances. The policyholders receive the actuarial reserves plus the interest and capital bonuses credited. If no other solution is possible once the life insurer has defaulted, policyholders of collective institutions may join the Pension Law backup scheme. This backup scheme is an institution that has borne its risks autonomously since 2005.

6. The responsibilities of FOPI
In the normal case, the collective institutions do not bear risks under the Pension Law, but rather, the risks are transferred to the life insurers. For this reason, FOPI as the supervisory authority has the following responsibilities:

FOPI monitors whether

- the insurance contracts between the collective institution and the life insurer are properly concluded;
- the life insurer is solvent and whether it fulfils the own funds requirements and/or to what extent it exceeds these requirements;
- the life insurer is always able to fulfil its obligations. In this regard: The demands of the collective institution must be covered by the life insurer through capital investments, and transactions subject to the Pension Law must be covered by own funds. FOPI monitors the Pension Law business on the basis of the reports of the private life insurers.

FOPI also monitors

- the rates and terms and conditions of the contract and approves them. This material supervision is also maintained under the new supervision law with respect to occupational pensions (new ISL, article 4, paragraph 2, subparagraph (r)).