

**Speech**

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## **Challenges confronting the pension system – options and limitations of monetary policy**

PK-Netz conference

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Ladies and gentlemen

I am delighted to be able to talk to you at this important event. It gives me the opportunity to explain our position in what is a difficult financial market environment for you especially as pension fund managers. The Swiss National Bank (SNB) is responsible for our country's monetary policy and not for its social policies, nor for its pension schemes. At the same time, however, it is important for us as the central bank that the occupational pension system should be able to fulfil its constitutional mandate: together with Pillar 1 – the Old Age and Survivors' Insurance scheme (AHV) – it is required to ensure that insured persons can maintain their previous lifestyle in an appropriate manner after retirement.

Solid funding is crucial for this, as a pension system must be financially sound if the population is to have confidence in it. Such confidence is, in its turn, of fundamental importance in ensuring that the occupational pension system can perform its key economic role. This consists of giving people the certainty that the assets they have saved in their pension scheme during their working lives will actually be available to them in their old age. A good pension system makes it possible for people to reliably plan their future material needs, and fosters security for individuals and stability for society. It is therefore a key precondition for the prosperity and development of a modern economy. A healthy pension system is central to ensuring social cohesion and is one of the cornerstones of Switzerland's success.

With its three pillars – AHV, occupational pension schemes and private pension provision – Switzerland has for several decades operated a comprehensive and well-functioning pension system. Our pension arrangements have been envied abroad, which is also reflected in the relevant rankings. In recent years, however, our country has lost considerable ground in this discipline (cf. chart 1).

Have we become worse, or have the others improved? Whatever one might think about such comparisons, it is in Switzerland's own interest to do everything it can to ensure that the pension funds – as key players in the whole system of pension provision – are able to manage the numerous challenges facing them as effectively as possible. In what follows, therefore, I will look at two important and specific challenges: the ongoing low interest rate environment and the rise in life expectancy. I will then set out what the politicians and the pension funds themselves could do to meet these challenges in the current situation. The SNB, too, has repeatedly been called upon to make a contribution. I would therefore like to outline what we can contribute – within the framework of our legal mandate – to the health of the pension system, and where our scope for action ends.

### **Low interest rate environment – increasingly difficult to meet benefit commitments**

The first challenge that you as pension fund managers have faced for some considerable time now is the persistently low level of interest rates. These low rates are prevalent not only in

Switzerland, but in all the major currency areas. For the pension funds, which traditionally have large holdings of interest-bearing investments, this situation naturally means lower investment income. In other words, the share of the ‘third contributor’ – the capital market – has diminished considerably. This makes it more difficult for the pension funds to meet their existing benefit commitments.

In the BVG, the Federal Act on Occupational Old Age, Survivors’ and Invalidity Pension Provision dating from 1982, the entitlements of insured persons as well as other key parameters, such as the conversion rate<sup>1</sup> and the minimum rate of interest,<sup>2</sup> were defined on the basis of certain assumptions.<sup>3</sup> These assumptions – e.g. for economic growth, inflation, and the average achievable nominal return – were based on empirical figures that were wholly plausible in the 1980s when the occupational pension system was calibrated.

For some years, however, interest on investments across all maturities has been exceptionally low. For a closer examination, it is useful to differentiate between the long and the short term. Let us first look at the development of long-term interest rates, represented here by the yields on Swiss, German and US ten-year government bonds since 1995 (cf. chart 2). There is a clear downward trend. The decrease in Germany – and therefore in the euro area – was even more pronounced than that in Switzerland. What are the causes? I would like to highlight some factors I consider particularly important. To some extent, this development is due to the fact that since the 1990s the efforts of central banks in the advanced economies to bring down previously high inflation rates have been increasingly successful. As a result, the markets deemed the central banks’ pledge to maintain price stability to be credible. Inflation expectations consequently became anchored at a much lower level than before. The amount of interest that investors would normally demand as compensation for future inflation thus also decreased. If this reduction in interest rates were to be taken into account accordingly in the aforementioned pension fund parameters, the lower return would not in itself be fundamentally problematic for the pension funds, as their invested capital would also be subject to less inflation.

In recent decades, however, the real rate of interest – i.e. the nominal interest rate less consumer price inflation – has likewise been falling (cf. chart 3). As central banks have only limited influence on the development of the long-term real rate of interest, other factors must have been at work. First, population ageing in the advanced economies has resulted in an increased propensity to save, which in turn has increased the supply of investable capital.<sup>4</sup>

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<sup>1</sup> The percentage rate applied to retirement savings to calculate the annual old-age pension.

<sup>2</sup> The minimum rate for the interest payable on retirement savings.

<sup>3</sup> The parameters apply first and foremost to mandatory insurance cover. Under the BVG, it is the portion of a salary between CHF 24,885 and 85,320 (the ‘coordinated salary’) that has to be insured. However, many pension funds pay benefits over and above this statutory minimum (‘non-mandatory’ pension insurance). Pension funds that provide ‘comprehensive’ insurance cover in excess of the minimum benefits prescribed by law can define a conversion rate applicable to all retirement savings, provided the pension actually paid is at least as high as the pension payable under the mandatory insurance.

<sup>4</sup> If life expectancy increases while the retirement age stays the same, the number of post-retirement years rises. Thus employees have to save more money than previously if they are to be able to spend the same amount each year in their old age.

Second, productivity growth is declining.<sup>5</sup> This reduces the return potential of investments and hence also the demand for capital to finance investments. The real rate of interest had to fall in order to balance supply and demand on the capital market.

### **Negative interest – still essential from a monetary policy perspective**

The decline in long-term interest rates also has implications for monetary policy and thus for short-term rates. What is known as the ‘neutral rate of interest’, i.e. the rate at which monetary policy neither holds back nor stimulates the economy under conditions of price stability, is also lower than it used to be. To achieve the same degree of monetary policy expansion in these circumstances, short-term interest rates must therefore also be lower now. This is one of the reasons why many central banks lowered their policy rates to zero or even into negative territory in the financial and debt crisis. It was because of this that the SNB, too, introduced a negative rate of interest on the sight deposits that banks hold with it.

We are aware that the negative interest rate is an unconventional instrument, and one that has side effects. That is why we subject the benefits of this instrument for monetary policy, as well as any resulting costs, to particular scrutiny. We will only maintain the negative interest rate for as long as the benefits outweigh the costs. We undertook the most recent evaluation during our September monetary policy assessment. This showed that the negative interest rate, and our willingness to intervene on the foreign exchange market as necessary, are still essential in order to ease pressure on the franc, thereby stabilising price developments and supporting economic activity. Only in this way can we fulfil our mandate – to ensure price stability while taking due account of economic developments – in the interests of the country as a whole. In September, we also adjusted the basis for calculating the exemption threshold, which defines the portion of a bank’s sight deposits at the SNB on which we do not charge negative interest. This adjustment reduces the overall burden imposed on the banking system by negative interest to the minimum required for monetary policy purposes,<sup>6</sup> while taking account of the possibility that the low interest rate environment may persist worldwide for some time to come.

While negative interest rates are unusual and should only be temporary, moderately negative rates are not fundamentally different in terms of their economic effects from interest rates above zero. As the negative interest rate has brought about an easing of financing conditions in the economy, companies are able to take out loans for investments at lower cost. For us, however, this so-called ‘interest rate channel’ is not of prime importance. Rather, it is the effect on the exchange rate that is decisive for Switzerland as a small open economy. With the negative interest rate, we can ensure that the traditional interest rate differential versus other countries is not eroded excessively. Any further narrowing of the interest rate differential

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<sup>5</sup> Other hypotheses relating to the fall in the real interest rate are discussed in the economic literature. However, they are likely to provide less of an explanation than the factors of ageing and declining productivity growth.

<sup>6</sup> The adjusted method for calculating the exemption threshold takes effect on 1 November. The income the SNB earns from negative interest is currently expected to almost halve.

would increase the upward pressure on the franc, which would lead to lower economic growth and higher unemployment.

The measures taken by the central banks to combat the financial and economic crisis – low policy rates, forward guidance on the expected course of short-term interest rates, and securities purchases – have undoubtedly increased downward pressure on the general level of interest rates in the short and medium term. But the decline in capital market rates, which we saw in the chart earlier, began long before the outbreak of the crisis. This reinforces the notion that when interest rates fall, it is the aforementioned powerful structural drivers which are at work – i.e. persistently lower inflation expectations, greater propensity to save and lower propensity to invest. From today's perspective, therefore, the neutral interest rate that is relevant for monetary policy is also below previous empirical levels. Consequently, short-term interest rates could remain below their usual levels even if the central banks normalise monetary policy again at some point in the future.

### **Longer life expectancy – success story and challenge**

Ladies and gentlemen, the low interest rate environment is a challenging situation for pension funds. And I cannot even give you an idea of when Switzerland will be able to return to positive interest rates. All I can say is that the timing will greatly depend on developments in the global economy and the performance of the international financial markets.

Another challenge that is sure to preoccupy you as pension fund managers is that of rising life expectancy – on the face of it a very gratifying development and, indeed, one of humanity's success stories. Rising life expectancy is not only influencing the propensity to save but is also having a direct impact on the pension funds. Given an unchanged retirement age, it steadily lengthens the average duration of pension payments. This in turn results in higher payments and extra strain on the pension funds.

The consequences of these developments are clear. Lower inflation and reduced real rates of interest are resulting in lower nominal interest rates and are thus diminishing the pension funds' earnings prospects. On the benefits side, increased life expectancy means that pensions are being drawn for longer, thus increasing the volume of savings capital needed to finance these benefits. As a result, the system becomes unbalanced.

### **Price stability – the SNB's contribution to a healthy pension system**

What could be done to find a workable solution? Which measures would make sense and which would not? Let me start at home, so to speak: at the SNB. People frequently call for the SNB to abolish the negative interest rate in order to significantly ease the pressure on pension funds. But if we think things through, would that actually happen?

If there were no negative interest rate, the franc would be even more attractive internationally and would appreciate. That would slow down our economy considerably, and unemployment would rise substantially. In this gloomy scenario, long-term interest rates would therefore

barely increase at all. Instead, the downturn in economic activity would cloud the outlook for Swiss companies – with adverse consequences for share prices as well. So you see, under current circumstances the earnings outlook for the pension funds would not improve significantly if the negative interest rate were to be abolished. On the contrary. Higher unemployment would impact on the economy and the pension system, as it would have the effect of reducing value added and hence the contribution base. At present, it would therefore not be in the pension funds' interest to abolish the negative interest rate.

So if it is not possible in the current situation for the SNB to abolish the negative interest rate, could it not at least use the income derived from it to alleviate some of the pressure on the pension system – for example by distributing this income to the pension funds as 'compensation'? In our view, this would not be a good idea either. Any linking of monetary policy to social policy raises the issue of potential conflicts of interest with the SNB's actual mandate. That would also be the case if income were committed in this way. To ensure that the SNB can fulfil its mandate, our decisions must be based solely on monetary policy considerations.

The current arrangements for determining and distributing profits take due account of the individual stakeholders' responsibilities: the SNB's responsibility for monetary policy, and that of the Confederation and cantons for fiscal and social policy. The law stipulates that the SNB's profits be allocated to the Confederation and cantons, which can dispose of them as they see fit. Transferring the income derived from the negative interest rate to the pension funds would not only result in a questionable mingling of monetary and social policy, it would also reduce the volume of funds available for ordinary distributions to the public sector. Ultimately, it would be a zero-sum game.

For the negative interest rate to have the desired monetary policy effect, it must be applied across all sight deposit accounts held at the SNB as far as possible. Making an exception for such an important investor category as the pension funds would severely impair this effect. Moreover, it is likely that other players which also perform economically relevant and socially useful functions – such as charitable foundations – would promptly demand the right to be treated equally. It was for similar reasons that we already had to turn down a request from your industry association in 2015 to operate non-interest-bearing sight deposit accounts for the pension funds.<sup>7</sup> Quite fundamentally, the introduction of a 'fourth contributor' in the form of the SNB would seem to depart from the rationale on which the occupational pension system is founded.

So how can the SNB make any contribution to the health of the pension system? By consistently and credibly pursuing a policy geared to price stability, the SNB is contributing significantly to a solid foundation. In the long term this will facilitate economic growth and prosperity in Switzerland and, in particular, also safeguard purchasing power. Ultimately, this

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<sup>7</sup> cf. Moser, Dewet (2015), *Herausforderungen der aktuellen Geldpolitik* ['Monetary policy challenges currently facing the SNB'], speech at the general meeting of the Association of Swiss Pension Funds (ASIP), Zurich, 8 May.

is one of the decisive factors in ensuring that our country can afford a social security network that is resilient and remains fundable. Stable prices are thus very important for pension fund members. However, price stability is also of utmost importance for the socially disadvantaged and pensioners, as they are scarcely able to protect themselves against an inflation-related loss of purchasing power. Like the pension system, price stability plays a key role in the Swiss success story. It is an accomplishment that is greatly valued – and today almost taken for granted – by the general public.

### **Pension funds – reacting with moderation and flexibility**

Ladies and gentlemen, the pension funds have not been idle in the last few years with regard to the challenges mentioned. As pension fund managers, you have shown moderation and great flexibility in initiating various measures to bring your pension funds' income and expenditure into equilibrium over the long term as well. On the investment side, the exposure to fixed-income instruments has been reduced – given the persistently low interest rates – in favour of equities and real estate (cf. chart 4). Furthermore, the pension funds have again become more active abroad, and are keeping their liquid assets to a minimum. Indeed, liquidity as a share of total investment assets is currently at a historic low (cf. chart 5).

You have also had to take action on the benefits side in order to balance income and expenditure over the longer term. These cuts are painful and have been directly reflected in people's insurance certificates. One example is the sharp reduction in the conversion rate for non-mandatory cover.<sup>8</sup> Moreover, the technical interest rate<sup>9</sup> has been lowered by 40% in the last ten years. This took account of the probability that income from the 'third contributor' would also be greatly limited in future.

Thanks to these measures, together with the favourable trend on the equity and real estate markets, the coverage ratio of the pension funds of private-sector employers has remained stable since 2015 – despite the aforementioned correction to the technical interest rate, which has the effect of reducing this ratio. These efforts are approaching their limits, however. As the adaptation of the portfolio structure is associated with increasing investment risks, larger fluctuations in value are to be expected in future. In addition, the measures implemented to date are not sufficient given the rise in life expectancy. All other things being equal, the longer average duration of pension payments calls for increased retirement assets.

What can be done about this? Only a limited number of adjustment mechanisms can be used to restore the equilibrium of a pension system. The first such mechanism relates to the pension funds' income – in other words, the contributions paid into these funds. Higher contributions by employees and employers would make it possible to accumulate more capital. The other adjustment mechanisms relate to pension funds' expenditures. To reduce

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<sup>8</sup> Pension funds have little scope for action with respect to mandatory insurance cover, as the conversion rate is fixed at 6.8% in the BVG.

<sup>9</sup> Discount rate applied when calculating future benefits. The lower the technical interest rate, the larger the amount of pension capital required. Investment income should be sufficient to finance the technical interest rate.

these outgoings, either benefits could be decreased or the period of benefit payments could be shortened. We do not express any preference as to which of these mechanisms is used. Making such a choice always involves a delicate balancing of interests, which is a matter for political circles rather than the SNB.

Under these circumstances, however, it is clear that there is unfortunately no easy, universal solution. Adjusting to the realities of the investment world and demographic change comes at a price. And something else is also clear: in a pension system like ours, in which the key parameters are defined in nominal terms, this price will keep rising until such time as the problems are tackled. But holding on to the status quo also comes at a price. For example, we are seeing a rise in redistributions from young to older insureds, which was never intended by the system. This is also why the term 'lifestyle', as used in the relevant article of the Federal Constitution, targets purchasing power rather than any nominal quantity.

### **Workable solutions can be found**

At the start of my talk I drew your attention to an international ranking of pension systems (cf. chart 6). In other countries, too, the population enjoys rising life expectancy while savers bemoan the low interest rates. Denmark and Sweden, for example, which are now ranked several places ahead of our country, have implemented far-reaching and thus painful measures to stabilise and modernise their pension systems. Denmark has linked the retirement age to life expectancy, and Sweden is making the level of pension payments directly dependent on demographic and economic developments. These two examples show that it is possible, even in this politically fraught area, to find workable solutions.

Ladies and gentlemen, the SNB is not responsible for social policy. But allow me to finish by stressing once again how important it is to us that Switzerland's pension system should continue to perform its pivotal economic and social function as well as possible. We are also aware of how critical the situation is for the pension funds, given the persistently low interest rates. At the same time, we cannot say when the negative interest rate will no longer be necessary. The SNB's contribution to a strong pension system is maintaining price stability in our country.

Adapting the parameters to economic and actuarial realities is an ongoing task of both pension fund managers and political bodies – in normal as well as exceptional times. As pension fund managers, you have fulfilled your obligations and have taken action in the very challenging environment of the past few years. Switzerland's political bodies, too, recognised some time ago that the pension system must take account of the economic realities. Some initial steps have already been taken along this rocky road. But there is still a way to go.



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# Challenges confronting the pension system – options and limitations of monetary policy

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PK-Netz conference,  
Berne, 31 October 2019

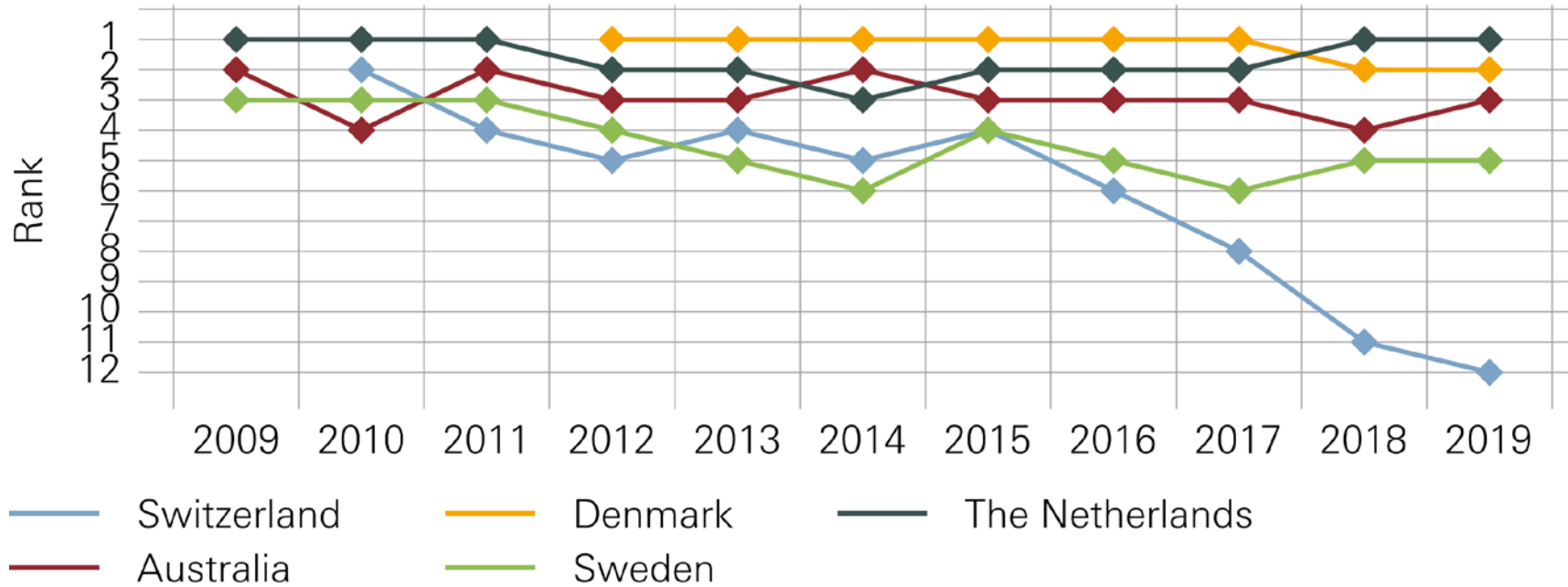
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# Chart 1

## INTERNATIONAL COMPARISON OF PENSION SYSTEMS

Mercer Global Pension Index

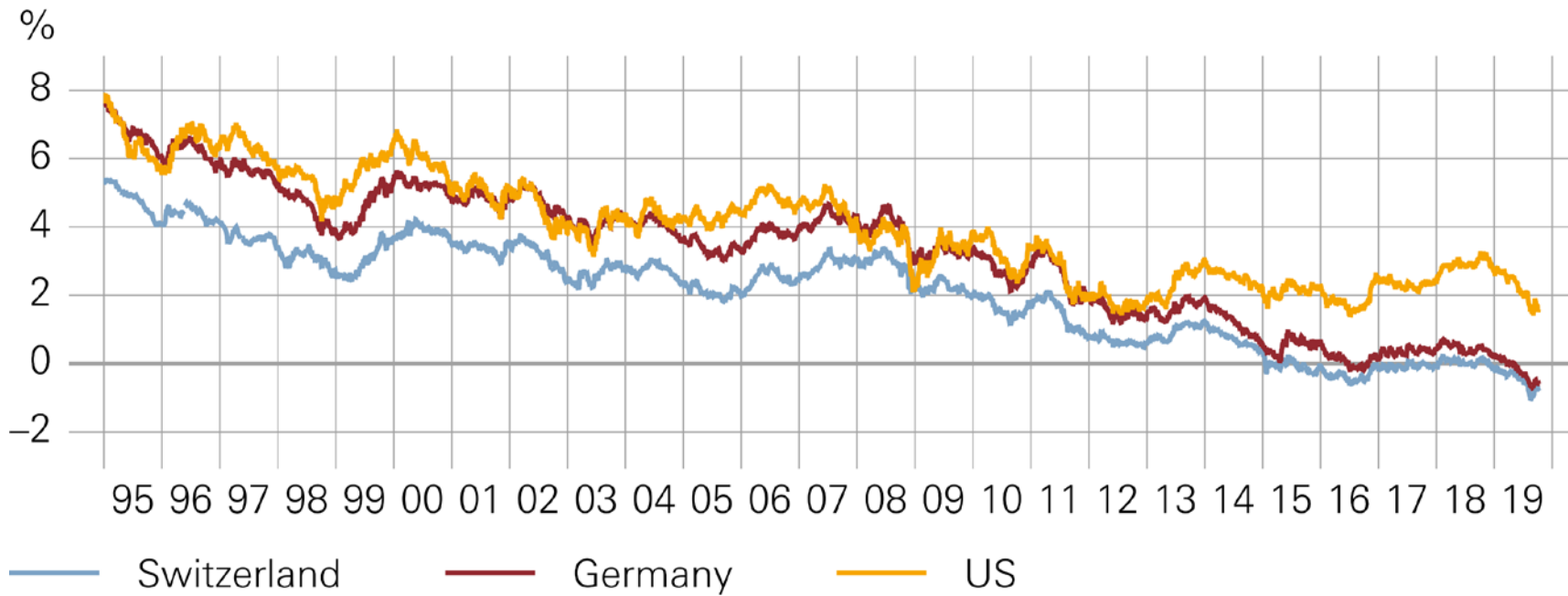


Source: Mercer

# Chart 2

## INTERNATIONAL LONG-TERM NOMINAL INTEREST RATES

10-year government bond yields

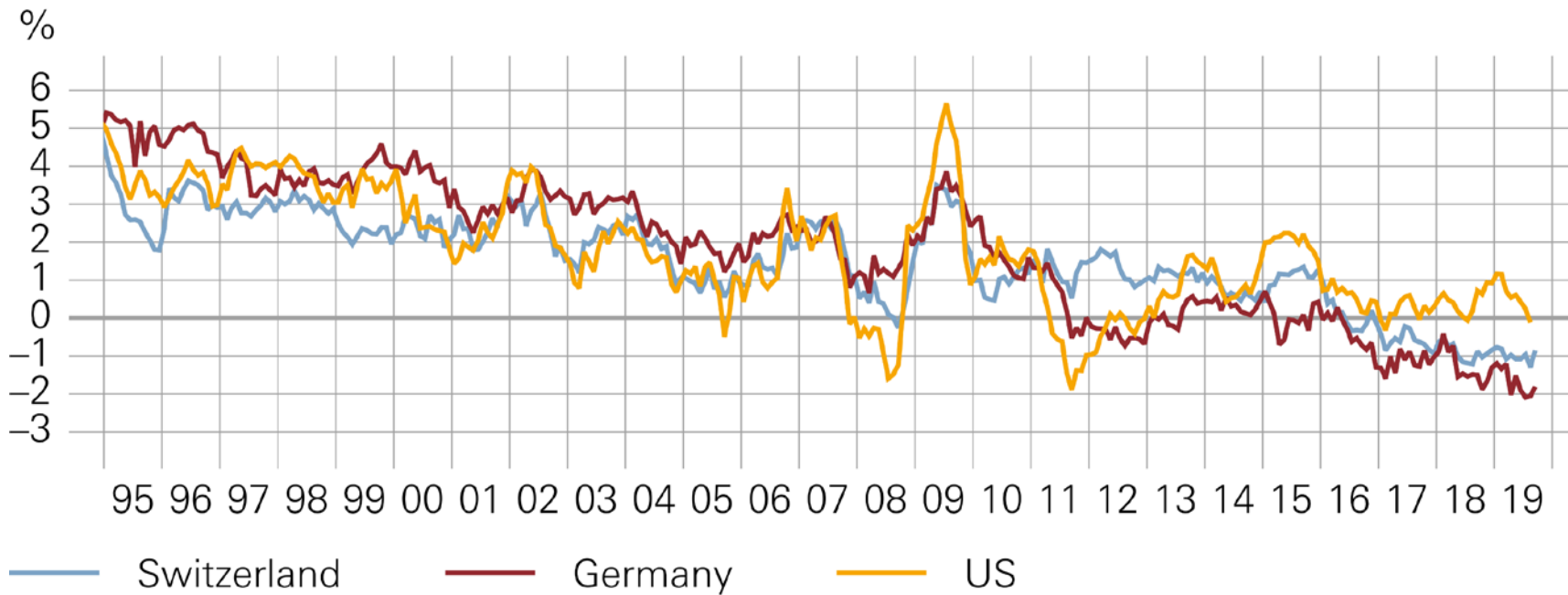


Sources: SNB, Thomson Reuters Datastream

# Chart 3

## INTERNATIONAL LONG-TERM REAL INTEREST RATES

10-year government bond yields minus consumer price inflation

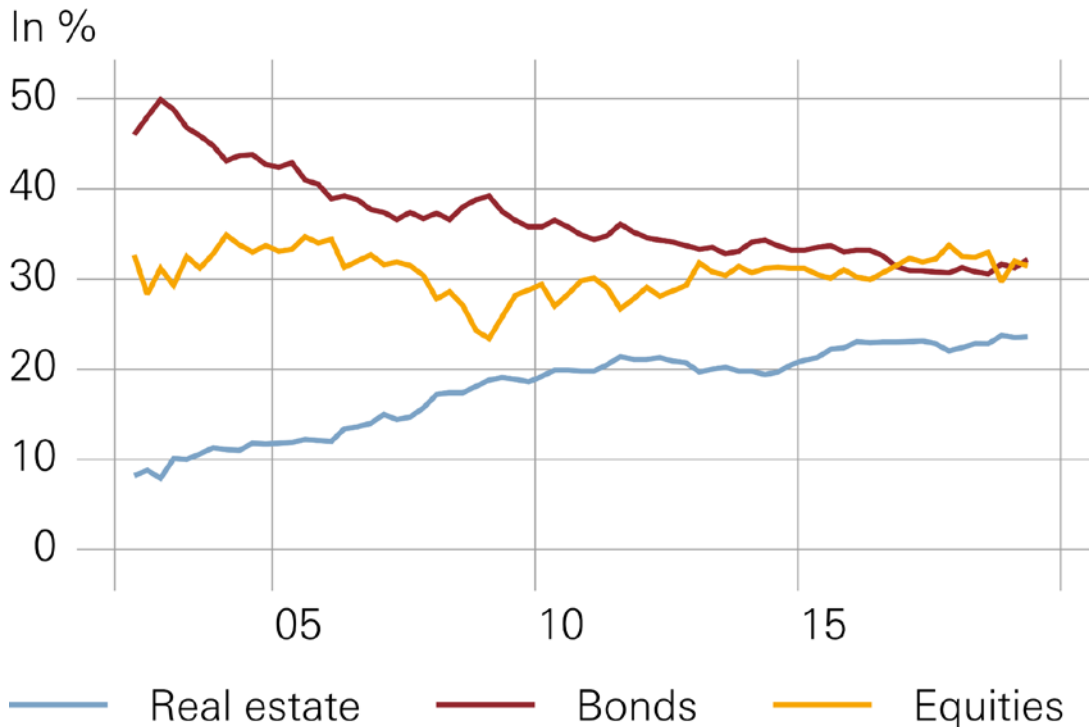


Sources: SNB, Thomson Reuters Datastream

# Chart 4 and 5

## MAIN ASSET CLASSES AT PENSION FUNDS

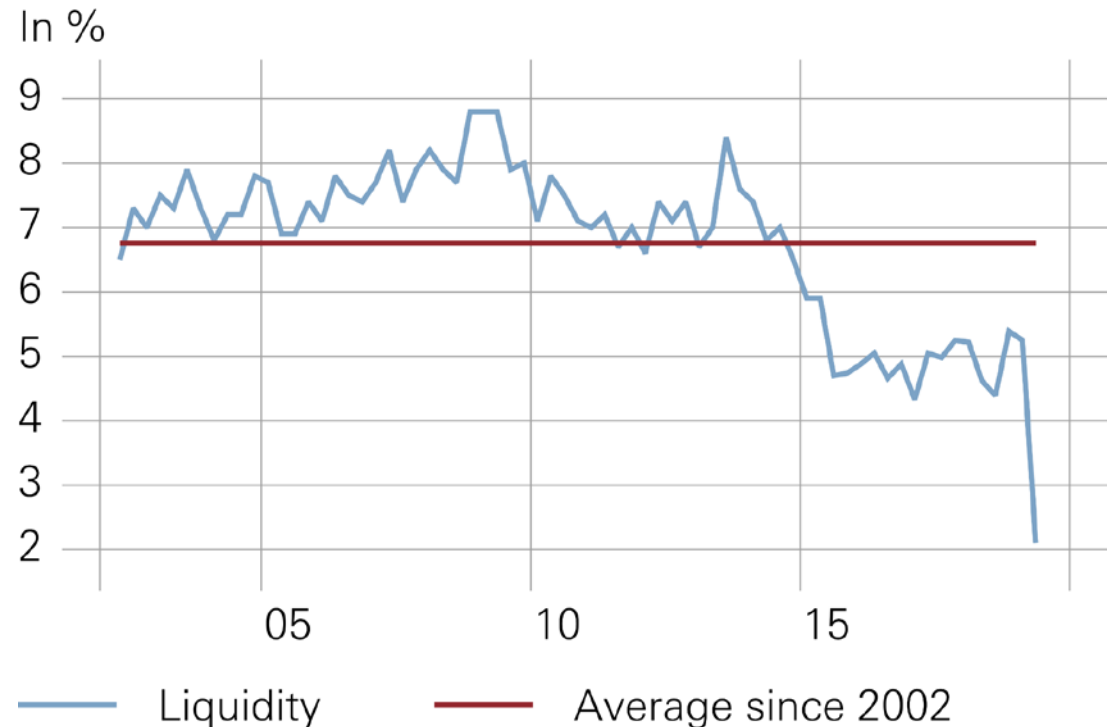
Share of total investment assets



Source: Credit Suisse

## LIQUIDITY AT PENSION FUNDS

Share of total investment assets

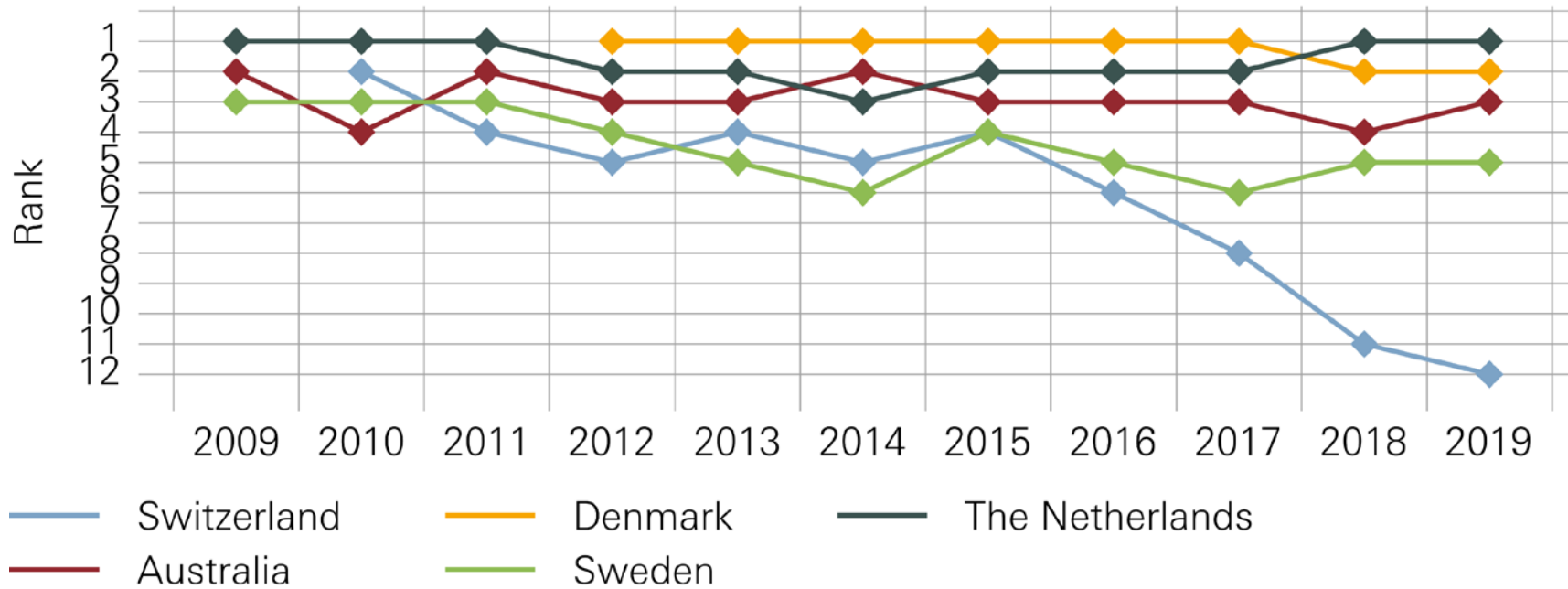


Source: Credit Suisse Swiss Pension Fund Index

# Chart 6

## INTERNATIONAL COMPARISON OF PENSION SYSTEMS

Mercer Global Pension Index



Source: Mercer