

Economico Flash ⚡ #52

Cost-benefit ratio of a pension fund: risk capacity



Chart of the week: Relationship between structure and risk level of pension funds



The topic of our 52nd anniversary flash is the risk capacity of a pension fund, an issue that has been a major focus of our company for decades.

It is desirable to have a pension fund with a high risk capacity, as such a fund can take on higher investment risks, which result in higher returns in the long term. High returns on investments as a "third contributor" lead to higher benefits in the long term.

How can the risk capacity of a pension fund be measured? In Art. 50 para. 2 BVV 2, the legislator "offers" two measures for assessing risk capacity: firstly, the ratio of "total assets and liabilities" and, secondly, the "structure and expected development of the insured population."

The ratio of assets to liabilities can be summarized in simplified terms as the pension fund's coverage ratio. In Flash 49, we wrote that it is a good thing to be with a pension fund that has a high coverage ratio. However, this argument is based primarily on performance: with a pension fund that has high reserves and a correspondingly high coverage ratio, the prospects are good that higher benefits (e.g., in the form of higher interest rates) will follow in the coming years.

However, the coverage ratio has glaring weaknesses as a basis for assessing risk capacity and choosing strategic investment risk. The coverage ratio is a snapshot measurement that can change rapidly on a daily basis due to stock market fluctuations.

When the stock market rises, the coverage ratio increases and with it the risk capacity. If one relies on this measure, one would have to increase equities when they are at their highest. If the stock market falls, one would have to sell risky equities when they are at their lowest.

The resulting procyclical investment behavior is poison for long-term investment returns. If the slump is severe and the pension fund falls into underfunding, the pension

fund also faces the so-called "gambling for resurrection" dilemma. In this situation, it actually needs the returns from risk-bearing investments in order to work its way out of the shortfall, but based on the coverage ratio, it no longer has the risk capacity to hold such investments in its portfolio. The coverage ratio as a measure of a pension fund's risk capacity is not weatherproof.

The composition of the insured structure is a weatherproof alternative for measuring the risk capacity of a pension fund: a young pension fund with many active insured persons and few pensioners has a positive cash flow on balance, and the balance sheet total grows annually. This balance sheet growth continuously "washes out" any shortfalls or surpluses in the balance sheet. In a pension fund with a high proportion of pensioners, the balance sheet shrinks and any shortfalls or surpluses that occur become increasingly pronounced. Our conclusion: young, growing pension funds can cope with high investment risks, unlike pension funds with a high proportion of pensioners. This view is shared by many pension funds: according to the chart of the week, pension funds with an active share of < 60 percent are reducing the proportion of high-risk tangible assets in favor of low-risk nominal values.

Takeaways

- The coverage ratio is not a reliable measure of a pension fund's risk capacity.
- A young structure and the resulting positive cash flow give a pension fund stability and thus risk capacity.