Swiss Pensions Funds and the Determinants of Free Cash Flow*

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Abstract

The persistently low interest rate environment as well as the demographic trend pose major challenges to the Swiss occupational pension scheme. How successfully the foundation's Board of Trustees manages the pension fund is usually expressed by the actuarial funding ratio. This is the ratio between pension funds' total assets and its liabilities. Since the valuation of liabilities heavily depends on actuarial principles set by the Board, the level of funding ratio is not comparable across pension funds. However, as soon as a pension fund has reached its target fluctuation reserves, which means that it is able to fully offset capital market risks according to its investment policy, it reports free cash flow. Regardless of the size, we therefore assume that reporting free cash flow is an indicator for financial stability of a pension fund. Based on a large pension fund panel from the Swiss Federal Statistical Office, we observe that the two groups - having or not having free cash flow - have a large overlap in terms of the level of actuarial funding ratio. We use logistic regressions to study the relationship between pension funds' main free cash flow drivers and the two defined groups. The first results indicate that a pension fund is more likely to reveal free cash flow if the share of risk-bearing assets is small and the investment fluctuation reserves are high. This implies that pension funds rather pursue a conservative investment policy although the financial risk capacity is given. However, when valuing the liabilities, pension funds tend to use a higher actuarial interest rate compared to the reference interest rate.

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