

I. At the beginning of this review it seems necessary to give you a short introductory survey about the fundamental characteristics of the German system of supplemental private employee pensions and the respective Insolvency Insurance.

1) The Pension System.

According to the results of a Federal Government statistical enquiry on private employee pension benefits by the end of 1973 approximately 7 mill. employees in the private sector (= 61 % of total) had been granted employee pension benefits by their employers. The percentages of the different forms used were:

	<u>%</u>
<u>Table 1</u> pension promise (book reserve system)	50.8
support fund (Unterstützungskasse)	<u>37.8</u>
	88.6
pension fund (Pensionskasse)	6.4
direct insurance	<u>5.0</u>
	100.0
	=====

As for the corresponding expenditure, the two first mentioned financing methods (pension promise and support fund) together were 90.9 % of the total volume, leaving pension fund and direct insurance with only 9.1 %.

These proportions were the result of a long development mainly influenced by tax law and labor law. The German book reserve system and also the support fund system had proved to be very flexible and efficient. The financial impact of the book reserves, particularly self-investment under favourable tax provisions, would be higher productivity thus contributing to earning the money for paying the pensions when falling due.

Pension funds and direct insurance contracts are under strict Federal Insurance Supervision control and -- apart from a special type of direct insurance -- grant the employees of the sponsoring employer irrevocable claims against the pension fund or the insurance company, the reserve capital being separated from the employer's business and its risks.

The two main German forms, however, -- pension promise under book reserve plans and support funds -- lacked the security that the promised benefits would be paid at any rate: they depend on the solvency of the employer who is liable for paying the pensions. And his pension liabilities as a rule are "funded" in his own business so that the corresponding business assets are not out of the reach of his creditors (Internal funding). Also the support fund usually has most of its means invested in loans to the employer so that the risk situation of this "quasi-funding" is similar. Therefore insolvency cases in former years

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resulted in the total or partial loss of pension rights of employees and beneficiaries. The same was true for the special type of direct insurance with only revocable rights.

It was apparent that this could no longer be tolerated when the federal parliament discussed the new

"Law on the improvement of employee retirement benefit programs" (Gesetz zur Verbesserung der betrieblichen Altersversorgung, BetrAVG) - eventually enacted in December 1974, the same year, when ERISA was enacted.

2) The System of Insolvency Insurance

Apart from establishing minimum vesting standards and certain conditions for the escalation of current pensions, the law provided for better financial effects of the book reserve system than before by improving the tax provisions for the deduction of allocations to book reserve. On the other hand a mandatory insolvency insurance was installed to prevent any future losses of employee pension benefits, current pension payments and vested rights, in consequence of an employer's insolvency, covering -- within certain limits -- the three forms of financing employee pension benefits that rely on the employer's solvency:

book reserve system

support funds

and direct insurance with revocable rights or policy loans on it.

This insolvency insurance might have been performed by a Government department or agency. But the Federation of German Employers' Associations suggested that -- taking the private character of occupational pension programs into account -- it was more suitable and adequate to use a privately organized carrier of insolvency insurance. They promised to let the job be done by the PENSIONS-SICHERUNGS-VEREIN (PSVaG), which had been founded as a mutual insurance association for that particular purpose in October 1974 by the Federation of German Employer's Associations (BDA), the Federation of German Industries (BDI), and the Federation of German Life Insurance Companies.

The law (sec. 14) instituted the PENSIONS-SICHERUNGS-VEREIN (PSVaG) as the carrier of the mandatory insolvency insurance and authorized the PSVaG to raise contributions of compulsory character, thus acting similar to a Government corporation (so-called endowed enterprise). Start of the PSVaG's operations was on January 1, 1975.

Insurance provided by the PSVaG is payable only in case of the insolvency of an employer. Termination of a private employee retirement benefit program is not an insurable event.

The actual payment of the guaranteed pensions is not done by the PSVaG itself, but by a consortium of the German life insurance industry, based on single premium insurance contracts with the PSVaG.

The financing system of the PSVaG is a modified loss repartition system with a uniform contribution rate for all members no matter what the actual solvency situation may be. So there is no need for any monitoring in this respect on the contribution side.

The members of the PSVaG must report the contribution bases to the PSVaG each year until September, 30. Roughly speaking, the contribution basis is the capital reserve value of the pension rights. In most of the cases it can be taken from the computation of the book reserve or reserve capital for tax purposes. Thus the dimensions of an employer's pension promises are represented adequately.

The calculation of the contribution rate takes place in November each year, the figures on the loss side being updated on the whole year.

Table 2 The calculation formula is as follows:

expenditure

claims volume (mainly single premiums to the consortium
a) for benefits due out of claims of the current year
b) for new benefits due out of the vested entitlements of former years' insolvencies),

administrative costs of the PSVaG,

interest on foundation share capital
(initial and transitional provision of capital by guaranteeing members in order to set up the PSVaG),

allocation to the equalization fund,

allocation to a loss reserve.

income

interest earned on investments,

surplus distribution from the consortium for the previous insurance year,

receipts out of bankruptcy proceedings, take-over of assets of support funds etc.,

remainder: necessary contributions.

$$\text{contribution rate} = \frac{\text{necessary contributions}}{\text{total contribution base}}$$

The total amount of necessary contributions is related to the total amount of contribution bases for that particular year. The thus calculated rate is the final contribution rate. It is fixed by the managing board of the PSVaG with the consent of its supervisory board. There is an on-account payment due in March each year; the final payment is to be made in December.

3) Comparing the US system und the German system, these are the main differences:

- a) In USA "external funding" is favored by tax law, in Germany "internal funding". Internal funding, however, means having the whole employer's pension obligation under the risk of insolvency.
- b) Termination of a pension scheme or termination of a business or a plant is not an insurable event in Germany. Apart from some less important special cases it is the employer's insolvency that matters.
- c) In the USA the protection of the participants' pension benefits is done by a Government Corporation (PBGC), in Germany by a privately organised institution (PSVaG) that was given the authority to act as a mandatory insurer and to raise mandatory contributions.
- d) In the USA the contribution rate must be enacted by the congress and will be unchanged for at least several years. In Germany the contribution rate is fixed annually by the PSVaG's managing board with the consent of the PSVaG's supervisory board according to the criteria required by law. Roughly, these are the contribution base of that particular year on the one hand and the

losses resulting from the insolvency cases of that particular year plus losses resulting from former years insolvencies' vested rights reaching pay status in that year.

But, as the contribution rate of each year is fixed ex-post according to that particular year's total losses, this system means high flexibility and does not produce deficiencies. On the other hand, there can be severe differences between the contribution rates of different years so that they produce zig-zag graphs in the course of the years.

It must be noted that in the German system the current pensions in pay status are fully funded each year, whereas the vested rights that are not yet due will not be funded at all until they reach pay status.

II) Review of Operations

Table 3 on p. 66 shows that the PSVaG's activities and problems have been accelerating in the past few years.

The statistical peak can be seen in 1982, the 8th year of the PSVaG's operations.

The total amount of claims (and, consequently, the total premium income), the number of beneficiaries, and the number of vested entitlements of that particular year 1982 were more or less equal to the respective accumulated figures of the seven preceding years.

The main reason was the AEG-TELEFUNKEN insolvency case -- until then the PSVaG's third largest member -- which produced more than 75 percent (=app.950 Mio.DM) of 1982's total amount of claims. Mainly due to this factor the contribution rate had to be multiplied from 0.2 percent in 1981 to 0.69 percent in 1982, although 145 Mio.DM of the equalization fund were used to subsidize the contribution rate by 0.1 percent.

Also the PSVaG's workload grew extremely; you will imagine that this case was a hard blow for the PSVaG in every respect. It really put the German Insolvency Insurance system and the PSVaG to the test. I am glad to say that they stood the test and proved the soundness and workability of both the system and the institution.

Of course the decision to fix the contribution rate at 0.69 % in order to generate the funds required by law brought about a number of angry, adverse letters from members. A few tried to sue us in the court, but were not successful. The great majority of members paid their contribution obligations timely. Of course the PSVaG had provided a lot of particular information about the requirements set by the law.

1) Among many other arguments that had to be answered there was the fundamental misunderstanding that -- similar to other social and private insurance contributions -- the PSVaG's contribution rate could only go further up and never be reduced again. We had to make it clear that the German system is an ex-post repartition system with contribution rates going up and down according to the particular year's losses, namely from new claims of retirees out of that year's insolvencies and out of vested rights of former years' insolvencies.

In 1983 the contribution rate could be reduced to 0.37 %. Of course it could not go back to what it had been before, because the un-financed vested rights had to be financed in that year to the extent of the vested pension rights reaching pay status, and moreover, because of the obligation to re-allocate some amount to the depleted equalization fund.

These two factors will also influence the rate in future years. It is hoped, however, that the trend of losses in the following years will allow a further reduction of the contribution rate level.

- 2) Another question of major interest raised by the insolvency of AEG-TELEFUNKEN AG was the size of contribution burdens imposed on the members of the PSVaG.

Obviously this can only be judged when defined as the relative burden, i. e. the ratio

$$\frac{\text{Insolvency insurance contribution}}{\text{total cost of the pension scheme.}}$$

This ratio had been less than 1 percent on the average prior to 1982, in 1982 the rough average was 4 percent, and in 1983 2.2 percent.

Although these average percentages describe a considerable relative burden, it seems bearable as compared to the much more important financial advantages of the law for the German private pension system which is guaranteed by the Insolvency insurance. These are:

- a) The improved deductability of book reserve allocations for pensions (partial value instead of the former present value) as from January, 1975.

The size of this financial improvement is much in excess of all the financial burdens imposed on the employers for Insolvency insurance, provided they make profits.

b) The relatively low assumed rate of interest -- 6 percent -- used for the computation of the book reserves and the corresponding allocations which are deductible for the tax.

3) Another argument was that "the small employers pay for the large employers".

Realizing that roughly 5 percent of the number of employers generate roughly 80 percent of the total contributions this cannot be accepted.

III) Issues

Resulting from almost ten years of experience with insolvency insurance a number of questions have been raised, some of them to be discussed and answered in the long run, others in the short run.

1) under long term aspects

a) The fundamental question is if the system will be workable and financeable even in view of the future demographic development and the structural changes of the economy. Will the burden imposed on the PSVaG's members be so severe that this will enforce a fundamental modification of the system?

We do not think so. The system has stood the big loss-test of 1982 in a remarkable manner, and in respect of the future prospects it must be taken into account that the vested rights are not financed in the year of the insolvency, but in the course of the future years and decades. These vested rights presently amount to a present value of roughly 2.1 billion DM (computed with an assumed rate of interest of only 3 percent), but they are frozen in, whereas the contribution bases will grow dynamically. The latter have almost doubled in the past nine years (see Table 4).

Therefore a damped influence on the future contribution rates can be expected.

Table 4

CONTRIBUTION BASES

1975 through 1983

<u>Year</u>	<u>Billion (Mrd) DM</u>
1975	73
1976	83
1977	91
1978	98
1979	108
1980	120
1981	134
1982	145
1983	149

In this context it is of fundamental importance that the Federal Supreme Labour Court decided in March 1983 that the PSVaG is not liable to sec. 16 of the Law on the improvement of private employee retirement benefit programs. That means: The PSVaG is not liable to adjust current pensions according to the rising cost of living, unless this had been expressly promised by the former employer, which is not the standard.

An average percentage of 1 - 4 for the insolvency insurance contributions as compared to the total cost of private pension schemes does not seem unreasonable or undue, particularly if the tax relief in the book reserve system is taken into account. The relative burden is less than that imposed on employers by law and jurisdiction for the escalation of current pensions according to the cost of living rises.

Therefore, a fundamental modification of the system does not seem necessary.

- b) The German system allows the changing-over from one form of financing pensions which is subject to insolvency insurance to another form which is not. So far we do not find that very often, because, for several reasons, the alternatives are not attractive.

If this would happen in a large number of cases, however, another problem would have to be solved: the problem of the unfinanced vested rights. In this case it could be appropriate to establish a compensation liability for withdrawing members who change over to forms not subject to insolvency insurance.

2) under short term aspects.

- a) A reduction in the limit for insolvency insurance coverage by law has been discussed. The present limit set by law is 3 times the Social Insurance contribution ceiling, i. e. $3 \times 5.200 \text{ DM} = 15.600 \text{ DM}$ per month in 1984.

As this affects only a few cases, the proposed legislative change in order to reduce the limit to the mere Social Insurance contribution ceiling was cancelled after thorough consideration.

- b) Moreover, there is a relative limit issue that has been discussed. So far, the PSVaG must cover the pension liabilities of the insolvent employer even if the total net retirement income of the retiree (including Social Insurance) exceeds his former net salary.

This is a very complex issue that has also been waived in the meantime, because any legislative solution of this problem would cause unreasonable administrative expenses for the employers and for the PSVaG. Also the problem should be a temporary one, because the employers themselves must prevent this situation by altering the pension promises within the range set by labor law.

The second aspect that lead to the cancellation of all considerations in this respect was the perception that any relative limitation of insolvency insurance coverage could only be defined in terms of an "integrated pension promise approach". In this concept the employer grants the deficiency between a certain percentage of the final salary, for instance, and the Social Insurance pension, thus being liable to compensate the retiree for lower retirement income from Social Insurance than had been anticipated. Of course, all employers who have had this approach so far, are trying to alter the system in view of the present and future difficulties of the Social Insurance. In this situation it would be the wrong way to use the integrated pension promise approach for legislative changes of the Insolvency Insurance.

- c) The great majority of insolvency cases causing the PSVaG's losses are cases of liquidation under the provisions of the bankruptcy act, i. e. the business of the employer comes to an end by the insolvency.

A few insolvency cases consist of reorganization proceedings for an ongoing employer. One of these was the largest insolvency case the PSVaG had to face so far; the PSVaG had to enter into 60 percent of the current pension payments and also into 60 percent of the pro rata temporis computed vested pension obligations of the employer that will become due in future years.

Under present law the PSVaG must assume irrevocable commitments to pay retirement benefits when due even if the ongoing employer earns profits in the future.

The PSVaG and its members feel that at least on the sector of the vested rights there should be a substantial relief for the PSVaG, either by returning the vested pension obligations to the -- then successfully operating -- employer or by instituting a right for the PSVaG to receive a profits interest, e. g. in form of a participating certificate, from the successfully operating ongoing employer. This approach could only be realized by legislative changes. In the political discussions this would surely find the opposition of other creditors, particularly banks.

- d) Another issue is to make sure that the law provides for mandatory allocations to the book reserves according to the pension promises granted to employees. So far this

is not mandatory but at the employer's discretion so that a company may -- in exceptional cases -- even pay dividends instead of caring for actuarially necessary and legally deductible provisions in the balance sheet, practically paying pensions in a pay-as-you-go approach.

In the executive board to the PSVaG we would vote in favor of an amendment to the law to make these allocations to book reserves mandatory but to allow a reasonable transitional period.

- e) In part I) of this report I pointed out that the contribution rate is a uniform contribution rate based on the actuarial capital value of the pension obligations. The contribution rate is not risk-related; no particular insolvency risk is taken into account.

Of course the development of the contribution rate in the past few years produced the question if it was not necessary to propose legislative changes in this respect. Particularly in the Federation of German Employers' associations a great deal of discussions was done to find out if this was appropriate. The conclusion of these discussions was, however, that no steps should be taken to have this approach realized by legislation.

On the one hand there was the argument that the insolvency insurance burden ought to be spread among the employers fairly according to their particular insolvency risks. On the other hand it was held that trying this would mean a highly complicated design of the procedure -- the higher the grade of perfection, the higher the specific administrative costs for the employers and the PSVaG. Also this would mean a significant multiplication of the contribution burden for the weaker employers, thus pushing a great number of them into insolvency.

Considering all aspects it was decided eventually not to pursue the risk-related contribution approach, but to maintain the present system.

PSVaG

DEVELOPMENT OF THE PSVaG AS OF JANUARY 1, 1975 UNTIL DECEMBER 31, 1983

Year	Members	On account contribution rate	Final contribution rate	Total contribution income	Insolvencies	Beneficiaries		Vested entitlements	Total balance sheet amount	Investments	Equalization fund	Members of PSVaG staff
						Total amount of claims (cash value)						
	Number (Dec. 31)	%	%	mio. DM	Number	mio. DM	Number	Number	mio. DM (Dec. 31)	mio. DM (Dec. 31)	mio. DM (Dec. 31)	Number (Dec. 31)
1975	31,045	0.15	0.15	110.6	249	74.7	5,060	7,290	93.2	82.9	34.4	36
1976	31,685	0.15	0.19	159.5	267	163.6	8,614	8,795	120.7	99.6	35.0	41
1977	32,102	0.17	0.19	170.9	246	128.2	4,745	5,808	198.6	175.0	88.3	42
1978	32,778	0.17	0.07	71.3	187	77.6	4,765	6,785	295.3	285.2	101.6	43
1979	32,518	0.05	0.11	119.0	154	127.5	5,346	8,116	265.2	228.8	114.3	48
1980	32,547	0.08	0.14	167.9	161	170.7	6,879	6,985	346.8	314.5	133.5	50
1981	33,895	0.09	0.20	268.9	246	276.9	11,780	13,228	477.0	456.5	156.1	59
1975-1981				1068.1	1510	1019.2	47,189	57,007				
1982	33,977	0.14	0.69	1002.1	355	1220.3	39,425	54,337	1293.9	1079.7	11.1	71
1983	33,746	0.00	0.37	550.7	300	516.9	10,799	14,208	663.4	622.6	128.3	81
				2621.1	2165	2756.4	97,413	125,552				

222,965

Table 3