

The Adjustment of Company Pensions A German Model — after Years of Discussion by Klaus Heubeck (Germany)

In Germany, the statutory requirements concerning the adjustment of current pension payments were enacted more than seven years ago. Sec. 16 of the German Act on the Improvement of Company Pension Plans requires that current pensions (not, however, future benefits: there is no comparable provision for these) be reviewed every three years and that both the pensioner's situation and the company's economic situation be reasonably considered when this review is made.

Under this general provision, the Federal Labor Court has handed down quite a number of judgments in the past few years. Most of these judgments have been disapproved both in theory and in practice. The Court has ruled that, in principle, the cost-of-living index must be used as the standard for adjustment and that the development of social security pensions cannot be taken into account, despite the fact that in most cases the pensioner's situation is mainly determined by the latter.

However, the Court deems it appropriate — and this is where it is in agreement with current opinion — to compare the situation of the pensioner with that of the active employee: the adjustment of current pension payments need not exceed the increase in the (net) income of comparable active employees of the company concerned.

In general, this maximization provision seems to make sense. Why should the pensioner be granted full compensation for the effects of inflation as far as his company pension is concerned if such compensation is not even possible for the active employee who works for an increase in the national product.

It would be reasonable to make such a comparison with respect to the available income, i.e. in the case of the pensioner, including his social security pension and its increases which, in Germany, in principle (still) follow the development of gross incomes. However, the supreme labor court has declined this view. It continues to follow its controversial detachment theory which considers the company pension as a separate unit detached from and independent of the social security pension, and it demands an individual comparison, i.e. an adjustment of company pensions in accordance with the rate of inflation, although not in excess of the increase in net income. This procedure ignores the fact that the development of the net income of active employees is not so much determined by the economic development of the company in question, as by overall economic factors such as the general business climate, growth, distribution of income and the development of taxes and contributions to social security schemes.

The adjustment of company pensions in accordance with the increase in gross incomes has no longer been discussed in Germany in recent years. The situation encountered in both the social security system and the civil service has shown that adjustment modalities of such a nature will involve undesirable consequences: both social security and civil service pensioners have had increases in income in the past few decades which exceeded by far those obtained by active employees and which have resulted in considerable increases in their standard of living after reaching retirement age. In a number of cases, these pensioners were even able to support their children who were actively employed.

As far as company pensions are concerned, such a development is neither desirable nor can it be funded, since pensioners account for an ever increasing percentage of the total population.

On the other hand, there is the question whether it will be sufficient to adjust company pensions only in accordance with the increase in the cost of living if the increases in the net income of active employees exceed this cost-of-living increase. The existing legal provisions do not require such an additional increase. Although it is still practised in Germany in a number of isolated cases, the tendency is for this practice to decrease. Following the concepts of adequate retirement income and social adjustment it

would be a consistent approach to provide the pensioner with a full share in the development of the real national product or real income, and this even in cases where increases exceed the rate of inflation.

As far as the overall economic field, i.e. social security, is concerned, this is something that is claimed in most countries. The problems involved in the realization of the claim are well known. As far as company pension plans are concerned, at least in Germany, the relationship between the financial possibilities of the company and such adjustment needs on the part of its pensioners has not yet been analyzed adequately.

The statutory obligation to review current company pension payments falls on the employer, irrespective of the funding agency chosen for the company pension scheme in question. However, in the case of direct insurance, pension funds and relief funds, it is generally assumed that the profits realized by these institutions are sufficient to cover the legally required adjustments. With a calculatory rate of interest of 3% to 3.5% (customary in the case of relief funds), which is prescribed by the German Supervisory Office, profits between 6.5 and 8% are realized at present. If these profits are fully allocated to the pensioners in accordance with their respective shares in the funds, there is the possibility of increasing their pensions in full or, as was usually the case in the past, partial conformity with the respective rates of inflation. If it is not possible to reach a full adjustment, i.e. if the economic capability of the direct insurance, pension fund or relief fund is not sufficient to hedge the pensions it pays against inflation, the legal situation in Germany places a corresponding supplementary obligation on the employer. Thus, the employer is in practically the same situation as when a company's direct pension commitment to a pensioner is funded by book reserves. When making the required review and decision, the employer is entitled to include the particular economic situation of the company in its considerations.

As well as considering the pensioner's interests, the Act also provides for the company's economic situation to be taken as an equal criterion in the adjustment requirements, although court rulings so far have not provided any additional clue to the legal and practical development of this criterion. In practice, the argument of a poor economic situation has been used in recent years to carry out any kind of partial adjustment ranging from zero (i.e. non-) adjustment to almost full adjustment. Because of the bad and uncertain economic situation, many bigger companies adjusted current company pension payments at a rate of only 60 – 80% of the full rate of inflation last year.

So far, there is only one complete model available with respect to the questions of how to measure the economic situation of a company in connection with the problems of adjustment and how to determine the actual rate of adjustment of the corresponding pensions. This model, which was developed by the ABA (Association for Company Pension Plans) and presented in publications (in both cases with the author's collaboration), is already employed in practice in a number of individual cases. It starts out from the basic concept that the pensioner is only entitled to claim an adjustment of his pension to the extent that funds are available for increased payments and for the corresponding present values. However, it is a prerequisite in this context that the company itself has not yet suffered from inflation, i.e. that it has been able to ward off inflation-related losses in its assets and, at least, to compensate for such losses by corresponding profits. As companies in Germany have to do their accounting on the basis of nominal values and as an inflation adjustment is neither customary under the various provisions of the German Commercial Code nor permissible for income tax purposes, the published balance sheets are only of limited value in the determination of the economic situation of a company. For the adjustment review, a so-called special "Preservation of Assets Statement" has to be prepared, as

is similarly required by the supreme board of the chartered public accountants for other purposes. As a result, such a statement determines those portions of (reported) profits which are necessary for the preservation of the company's assets and are therefore not included in the funds used for adjustments or similar purposes.

This method is not only a reasonable economic approach, it is also in keeping with the judgments which the Federal Labor Court has so far pronounced with respect to the economic situation of a company. The Court is right when it holds that priority must be given to the preservation of a company's economic efficiency to make sure that it will be able to meet future obligations including those for company pensions.

The profits not required for the preservation of a company's assets are available for other purposes such as the payment of dividends to the shareholders, further investments, the preservation and maintenance of the company and also the adjustment of pension payments. It is still an open question (which has so far been answered neither by way of court rulings nor in the aforementioned ABA model), which aspect should be given priority in this case. To ensure that the shareholders do not withdraw their funds from the company in the long run, it is certainly necessary that their capital yield a certain minimum rate of interest. This rate of interest would have to be higher than the rate of inflation and, on a long-term basis, reach the average yield obtained on the capital market.

The idea of putting aside part of the profits for increases in capital investment seems a problematic approach to me. In this case, concrete suggestions can only be made with respect to specific companies, since expanding companies have to be judged differently from companies in shrinking markets. In any case, however, the funds needed to maintain the company, i.e. needed for reinvestment purposes, will have to be set aside. Thus, funds

for the adjustment of pension payments are only available to the extent that the reported profit is not needed for the preservation of the company's assets, for paying dividends on the capital employed and for additional investments, if any. The total remaining profit can be used for an increase in pensions, i.e. for a corresponding increase in present values and thus for an increase in current payments. Should the company's funds be sufficient it would indeed be in conformity with the criterion of the economic situation of the company if adjustments were made which exceeded the rate needed to counter inflation. It is on this basis that the participation of pensioners in real (positive) economic growth can be justified.

Conclusion

In Germany, the adjustment of current company pension payments is handled as a practical procedure based on the existing legal situation. Even from the individual and overall economic points of view, this procedure may be a reasonable solution for the complex of problems and may also be feasible in other countries: The pensioner's adjustment needs are characterized by the inflationary devaluation of his total pension payments and are directed towards participation in the real development of incomes. The adjustment possibilities are determined by the economic efficiency of the company that is committed to the pension, although the company must give priority to compensation for inflation-related losses in its assets and make sure that its shareholders receive an adequate rate of interest. Apart from the pensioner's situation, it is above all these company-specific circumstances which the employer has to consider when making a decision concerning the rate of adjustment, a decision which the legislator was wise enough to assign to the employer and which must aim at the aforementioned economic targets within the scope of these possibilities.