

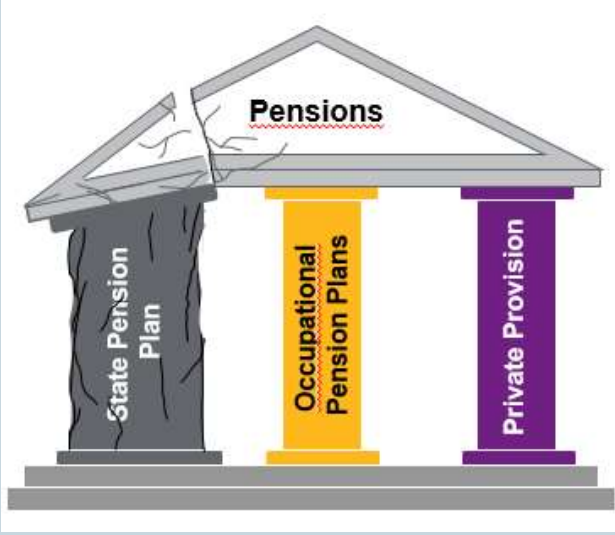
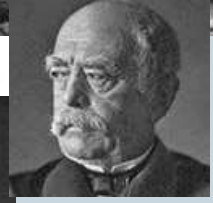
German Pension System

Experience and Challenges

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Berlin



Agenda

Overview German Pension Landscape

German State Pension System

- Milestones
- Key Facts
- Some Statistics



German Occupational Pension Plans

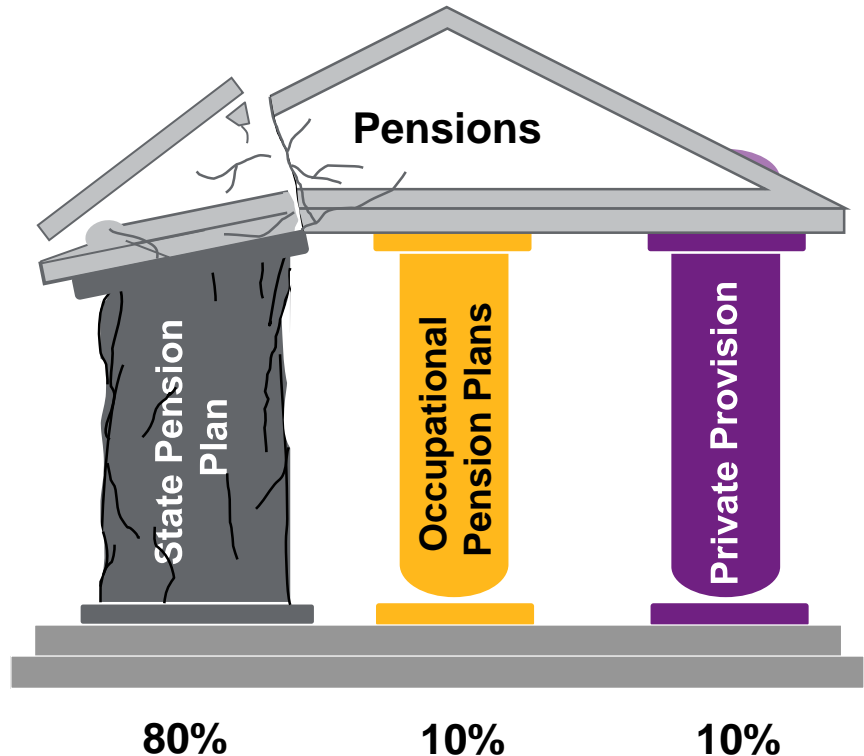
- Brief History
- Key Facts
- Some Statistics
- Occupational Pension Reform 2017



Overview German Pension Landscape

German pension system usually viewed as a „**Three-Pillar-System**“ with following elements:

- **Pillar 1: State Pension Plan**
(with separate plans for civil servants, public service and some so-called „free professions“ (doctors, lawyers, architects, farmers etc; *not discussed here*)
- **Pillar 2: Occupational Pension Plans**
 - (still) voluntary
 - 5 different financing vehicles
- **Pillar 3: Private Provision**
(insurance policies, real estate, bank products, cash savings etc; *not discussed here*)



Broad consensus in German politics for many years that the foreseeable benefit cuts in the State Pension Plan have to be offset by a strengthening of the other two pillars, mainly by **improving the basic requirements for Occupational Pension Plans !**

Milestones of the German State Pension System

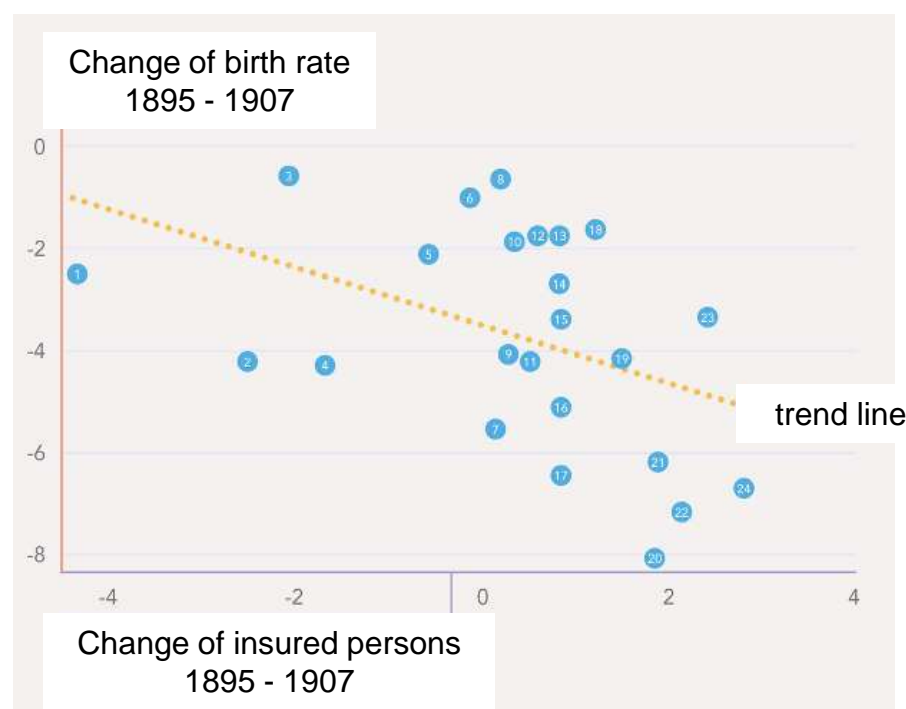
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It started with Bismarck's Social Security Laws in the 1880's ...

- **1881:** Chancellor **Bismarck** announces introduction of state-governed social security system for Germany.
- **1889: Disability and Old-Age Pension Law.**
 - **Retirement age was 70** – at a time when average life expectancy in Germany was 60 years (!)
 - Max. benefit level: 40 % of final salary.
 - At time of introduction: no survivor's pension.
 - **Partially funded system !**

→ Unintended consequence:
**Start of birth rate reduction
in Germany**

Source: Max-Planck-Institut for Demographic Research



Milestones of the German State Pension System

(2/4)

... and continued with Adenauer ...

- **1957**: Fundamental pension reform under chancellor **Adenauer** (CDU):
 - Pensions were linked to development of salaries and became **dynamic**.
 - New benefit formulae lead to **significant increase of pensions-in-payment**, on average between 40% and 90% depending on type of pension.
 - Combined employer and employee contribution rate was increased from 11% to 14%.
 - Change from a partially funded to a **pay-as-you-go system** (*Umlageverfahren*) based on **intergenerational contract** (*Generationenvertrag*), whereas the economically actives (and their employers) are effectively paying the pensions of the retired.



„People will always
get children“

Milestones of the German State Pension System

(3/4)

... to Brandt, Schmidt, Kohl and ...

- **1972: Expansion of State Pension System** under SPD-lead government (**Brandt, Schmidt**):
 - Introduction of **flexible retirement age of 63** (instead of 65) for longtime insured men (women could already draw an old-age pension at the age of 60).
 - Annual expenditures double between 1970 and 1975 from 52 to 101 billion DM.

- **1991:** After the fall of the Berlin Wall (1989) and German Reunion (1990) the pension system of former **East Germany** was transferred in State Pension System of former West Germany:



- **Exchange rate** for pensions from East Mark to Deutsche Mark was **1 : 1**.



- **East German pensions** were significantly increased, but remain **below average** West German pensions until today (especially for men).

Milestones of the German State Pension System

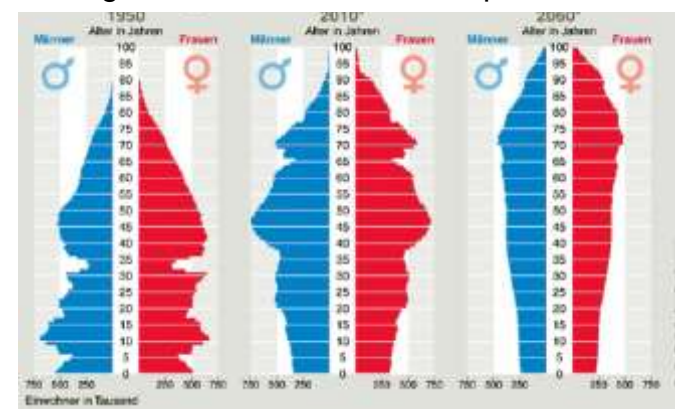
(4/4)

... finally to cost saving measures of Schröder and Merkel

- **2001:** Pension reform under **Schröder** lead to paradigm shift:

- State pension is still regarded as main pillar, but **importance of other pillars is emphasized** to maintain standard of living during retirement.
- Changed formulae for annual pension adjustments will lead to lower pension increases in the future, resulting in **lower replacement ratios**.
- **Introduction of Riester pensions** as voluntary, but heavily subsidized private pension schemes (designed as DC schemes with matching contribution from the state).

Age Structure of German Population



- **2007: Increase of normal retirement age from 65 to 67 years** with very long transition period (**Merkel**).

Key Facts of the German State Pension System

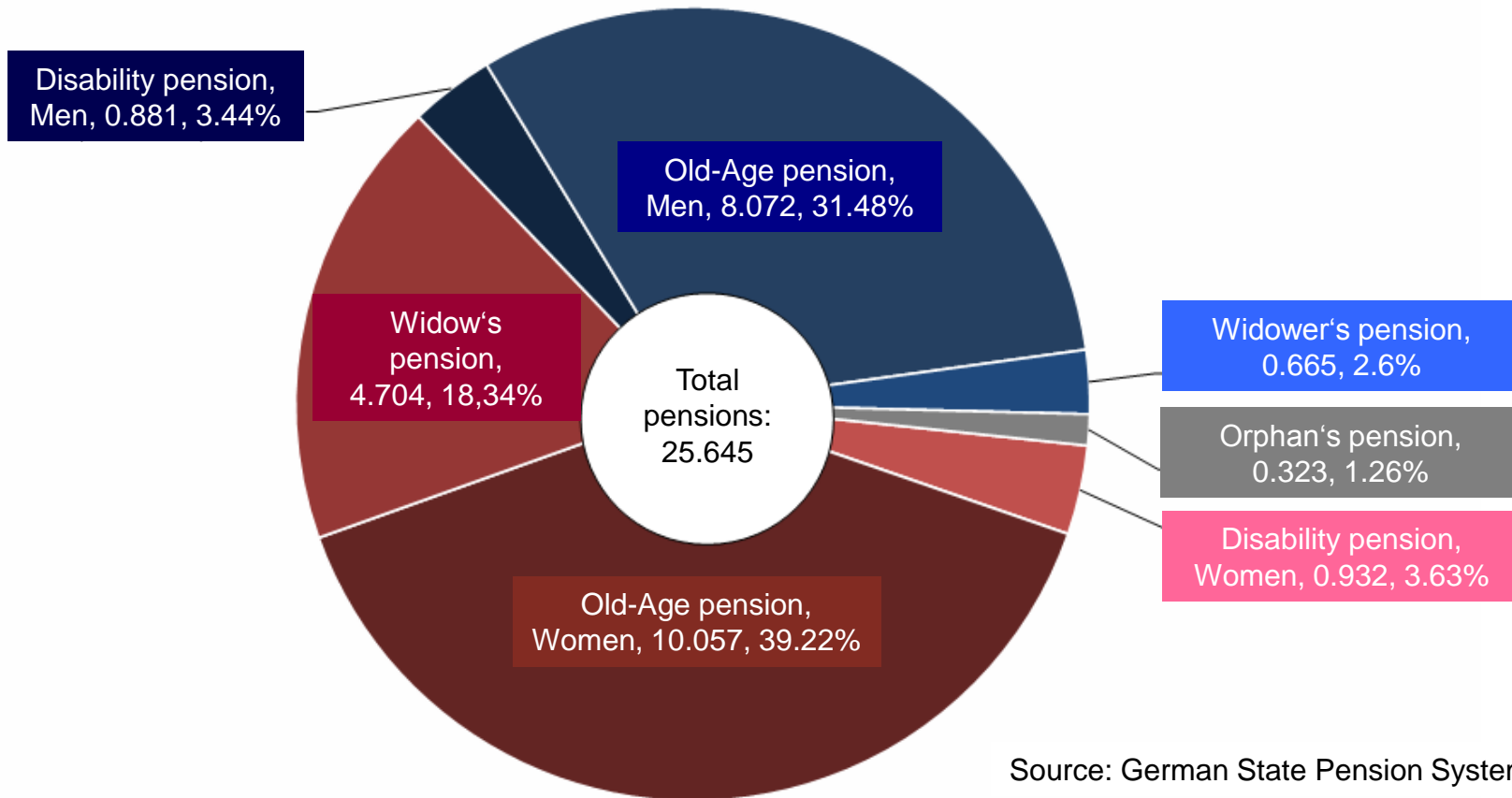


- **Compulsory** for all employers and employees. Only civil servants, self-employed and employees working in certain professions (for which separate benefit plans have been set up) are either exempt from, or may opt out of, the state plan.
- **Contributions** are borne by **employers and employees** in **equal shares** (in 2018 both contribute 9.3% up to the Social Security Contribution Ceiling SSCC of 78.000 €).
- **Unfunded plan** financed on a pay-as-you-go basis.
- **Benefits:**
 - Amount depending on insured years and contributions paid, which are transformed in „earnings points“ (*Entgeltpunkte*).
 - Old-age pension at age of 67 with reduction in case of early retirement.
 - Disability pension with granting of additional years (*Zurechnungszeit*).
 - 25% / 55% / 60% Widow/er's pension.
 - 10% / 20% Orphan's pension.
- Over the period 2005 – 2040 **taxation** is changed towards an EET model.

Some Statistics on German State Pension System

(1/5)

- Pensioners according to type of pension, men and women, as per 31.12.2016 (in Million and in %):

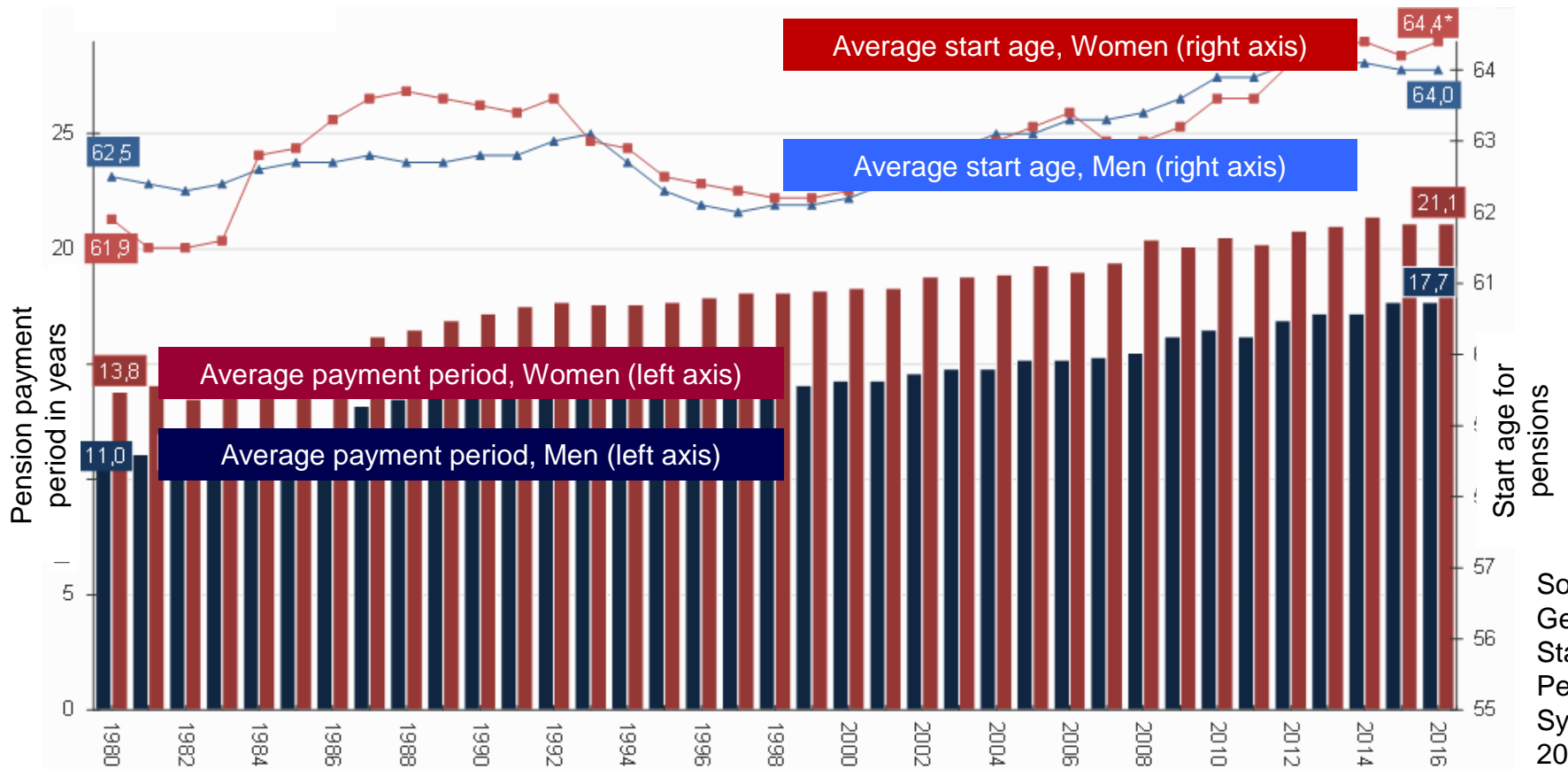


Source: German State Pension System 2017

Some Statistics on German State Pension System

(2/5)

- Average age at pension commencement (right axis) and average payment period (left axis), 1980 – 2016, Old states



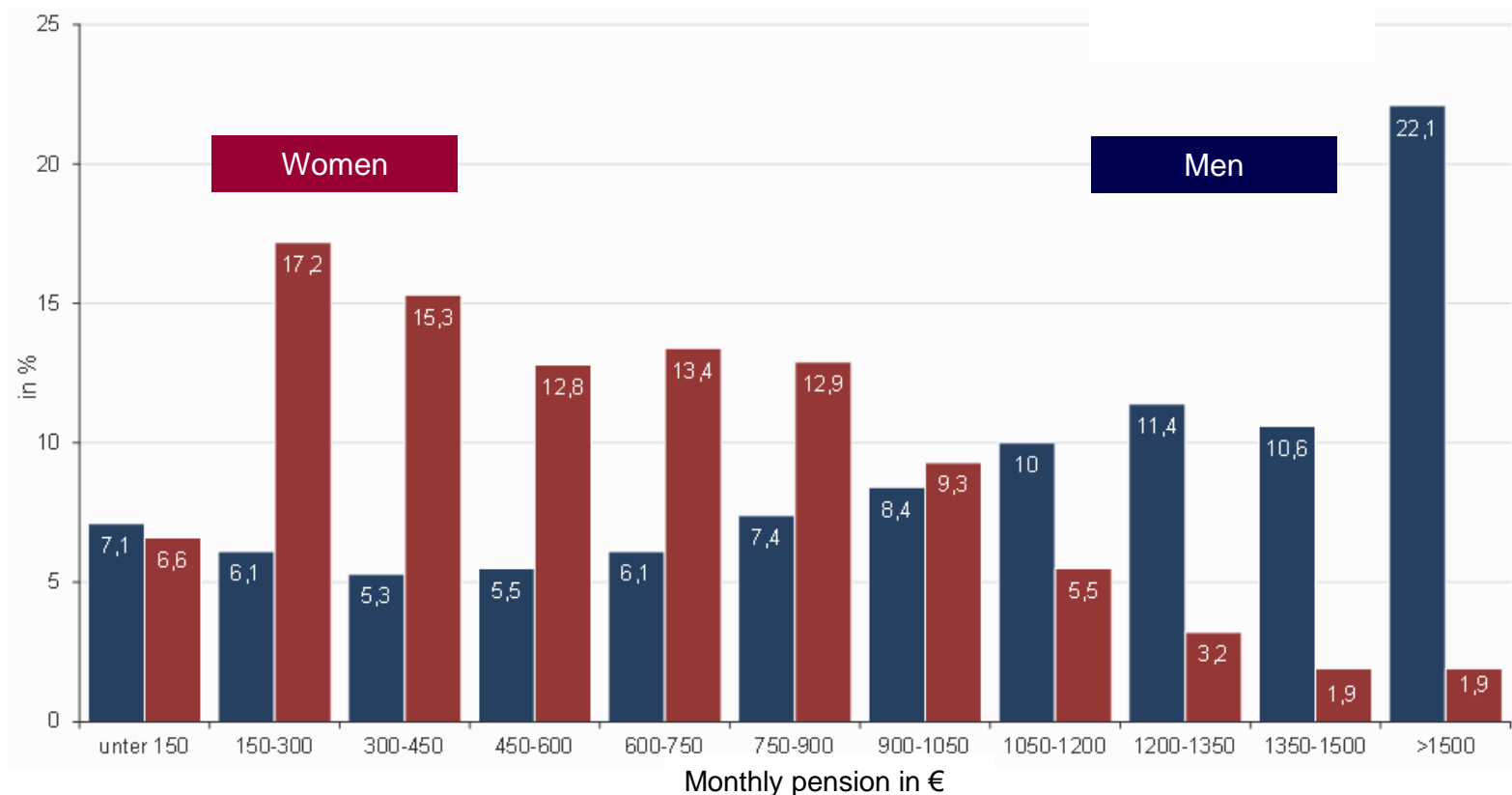
Source: German State Pension System 2017

Some Statistics on German State Pension System

(3/5)

- „Benchmark“ Pension (45 years of average contributions) at 01.07.2017:
 - Old states: 1,396 € per month
 - New states: 1,336 € per month

Distribution of monthly old-age and disability pensions, Old States, 31.12.2016, in %

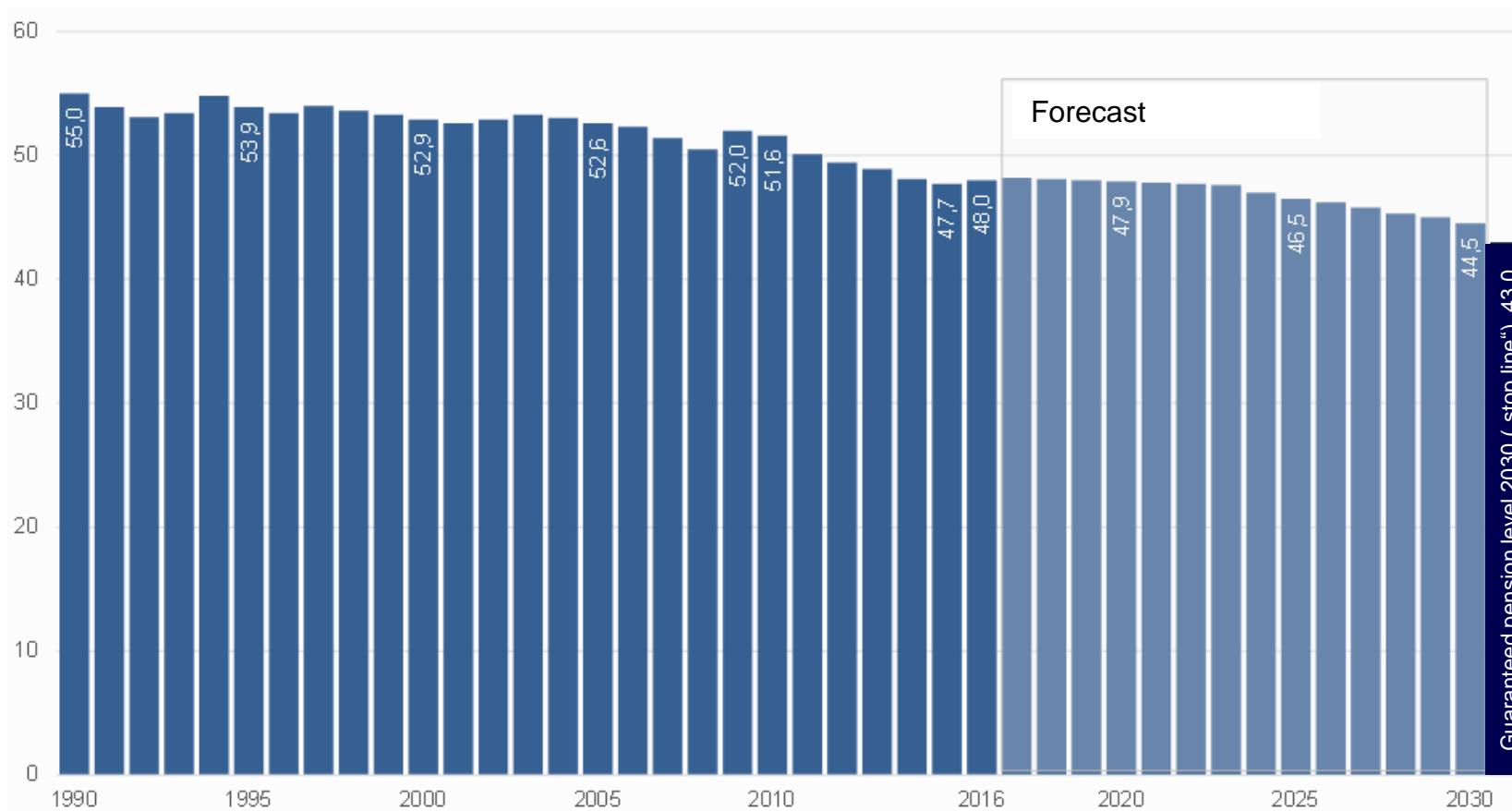


Source:
German
State
Pension
System
2017

Some Statistics on German State Pension System

(4/5)

- Development of the pension level before tax 1990 – 2030 for the „Benchmark“ Pension“ in % of average income (replacement ratio)

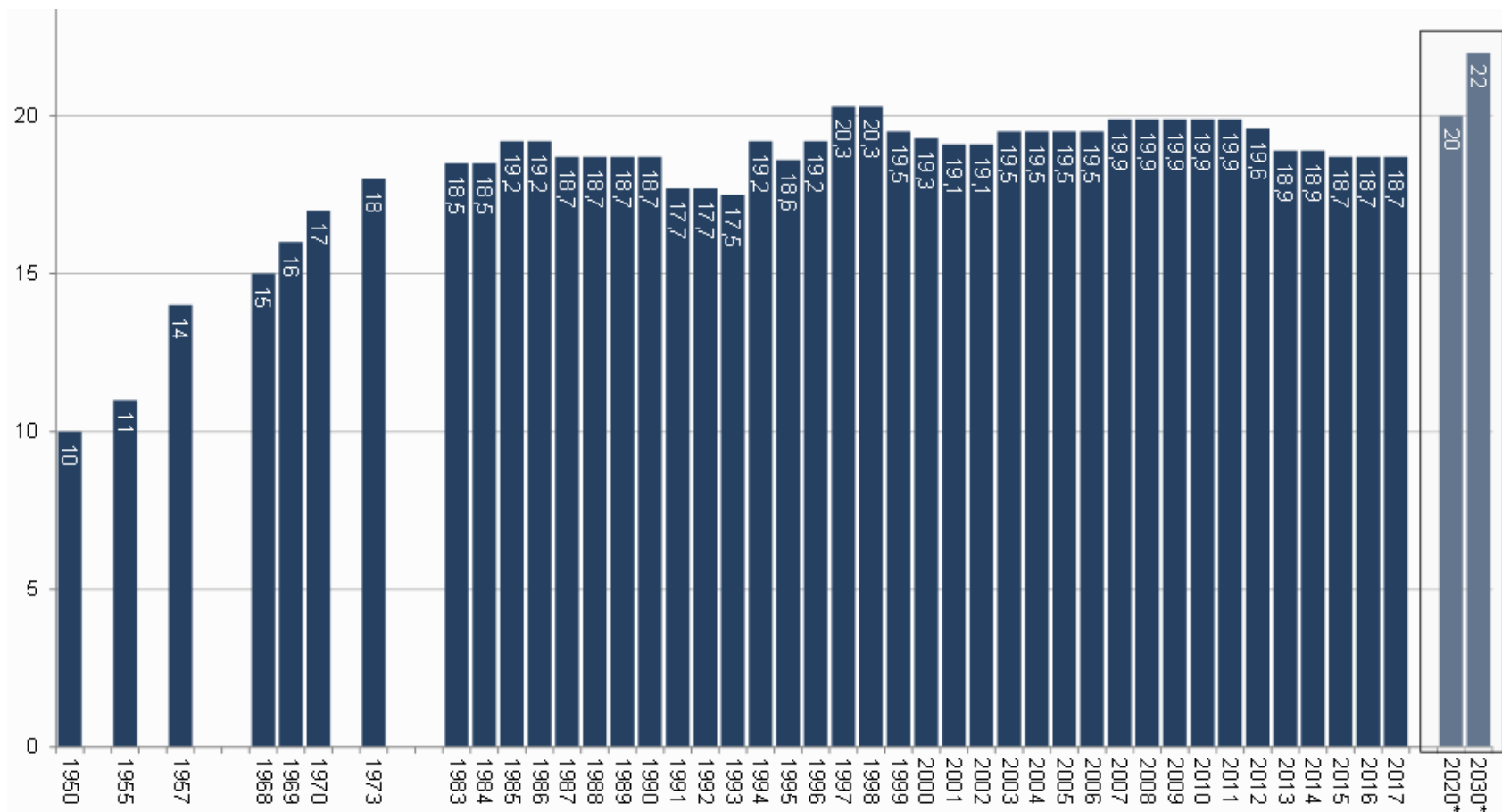


Source:
German
State
Pension
System
2017

Some Statistics on German State Pension System

(5/5)

- Development of contribution rates 1950 – 2017 and until 2030 (forecast)



Source: German State Pension System 2017

Brief History of German Occupational Pension Plans

(1/4)

Much older than any State Pension Plan

- Origin of occupational pensions in Germany can be traced back to **miner's organizations** in the middle ages to cover risks of this dangerous profession.
- The „**Goslar Certificate**“ (*Goslarer Urkunde*) from **1260** for local miner's social welfare is regarded as the **oldest document of a social security organization in the world** – more than 600 years before Bismarck.
- In **1426** the term **Knappschaft** was used for the first time and in the 16th century social welfare structure for miners became obligatory.



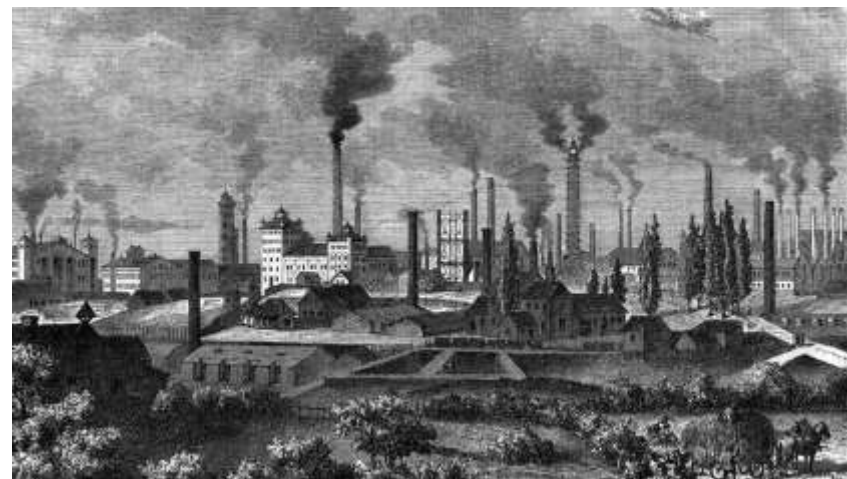
„You're a bit late, aren't you ?“



Brief History of German Occupational Pension Plans

(2/4)

- The **industrialization** in the **19th century** led to the founding of many occupational pension schemes, firstly of big German companies, later also in the form of multi-employer plans. Some of them still exist today:
 - 1819: Villeroy & Boch
 - 1832: Gutehoffnungshütte
 - 1858: Krupp und Henschel
 - 1871: Siemens
 - 1879: BASF
 - 1882: Farbwerke Hoechst
 - 1909: *Beamtenversicherungsverein* of the German banking profession (which later became the „BVG“)
- Most of these early plans were established in the legal form of a **Pensionskasse**, for which later the **Insurance Supervisory Law** (*Versicherungsaufsichtsgesetz – VAG*) of 1901 became applicable.



Brief History of German Occupational Pension Plans

1974: The most important year for company pensions in Germany



- **The milestone** for occupational pension plans in Germany was the „Law for the Improvement of Company Pensions“ (*BetrAVG*) in 1974.
- For the first time the legal framework for occupational pension plans in Germany was laid down in a systematic manner. Until that time „Case Law“ applied.
- The BetrAVG brought the following innovations:
 - **Insolvency protection** via the Pension Guarantee Corporation (*Pensions-Sicherungs-Verein – PSVaG*).
 - Legal provisions for **vested entitlements**.
 - **Mandatory indexation of pensions-in-payment** in case of a „solvent employer“.
 - **Direct Insurances** (*Direktversicherung*) were recognized as an own financing vehicle.
 - New rules for tax deductible book reserves in case of **Direct Benefit Promises** (*Direktzusage*).



Brief History of German Occupational Pension Plans

(4/4)

The renaissance of occupational pensions in 2001

- **2001:** After decades of stagnation the „**Retirement Savings Law**“ (*Altersvermögensgesetz*) brought fresh impetus for occupational pensions:
 - Employees received the **legal right to participate in a Deferred Compensation plan**.
 - **Pension Funds** (*Pensionsfonds*) were introduced as a new financing instrument.
 - Formal introduction of **contribution-related benefit promises with minimum guarantees**.
 - Compulsory membership in occupational pension systems was rejected at the time.
 - Driving force behind the pension reform was labor Minister **Riester** (SPD) after whom the heavily subsidized private **Riester pension** was named.



„I find 16.5 Million contracts extremely successful“ (2017)

Key Facts of Occupational Pensions in Germany



(1/2)

5 different financing vehicles possible (*Durchführungswege*)

- **Direct Pension Promise** (*Direktzusage*): Direct legal commitment of employer with internal financing by building up tax-deductible book reserves. Often voluntarily asset-backed via so-called contractual trust arrangements (**CTA**).
- **Support Fund** (*Unterstützungskasse*): External funding via a separate employer-controlled entity.
- **Pensionskasse**: External funding by a separate legal entity. Subject to supervision by the German Federal Financial Supervisory Authority (*BaFin*).
- **Direct Insurance** (*Direktversicherung*): External funding via a life insurance company with the employer as policy owner.
- **Pension Funds** (*Pensionsfonds*): Comparable to Pensionskasse, but with more freedom in investment decisions. Therefore, like *Direktzusage* and *Unterstützungskasse*, subject to contributions to the PSVaG (in contrast to the more *BaFin*-controlled Pensionskasse and *Direktversicherung*).

Key Facts of Occupational Pensions in Germany

(2/2)

Benefit Promise (prior to 2017 pension reform)

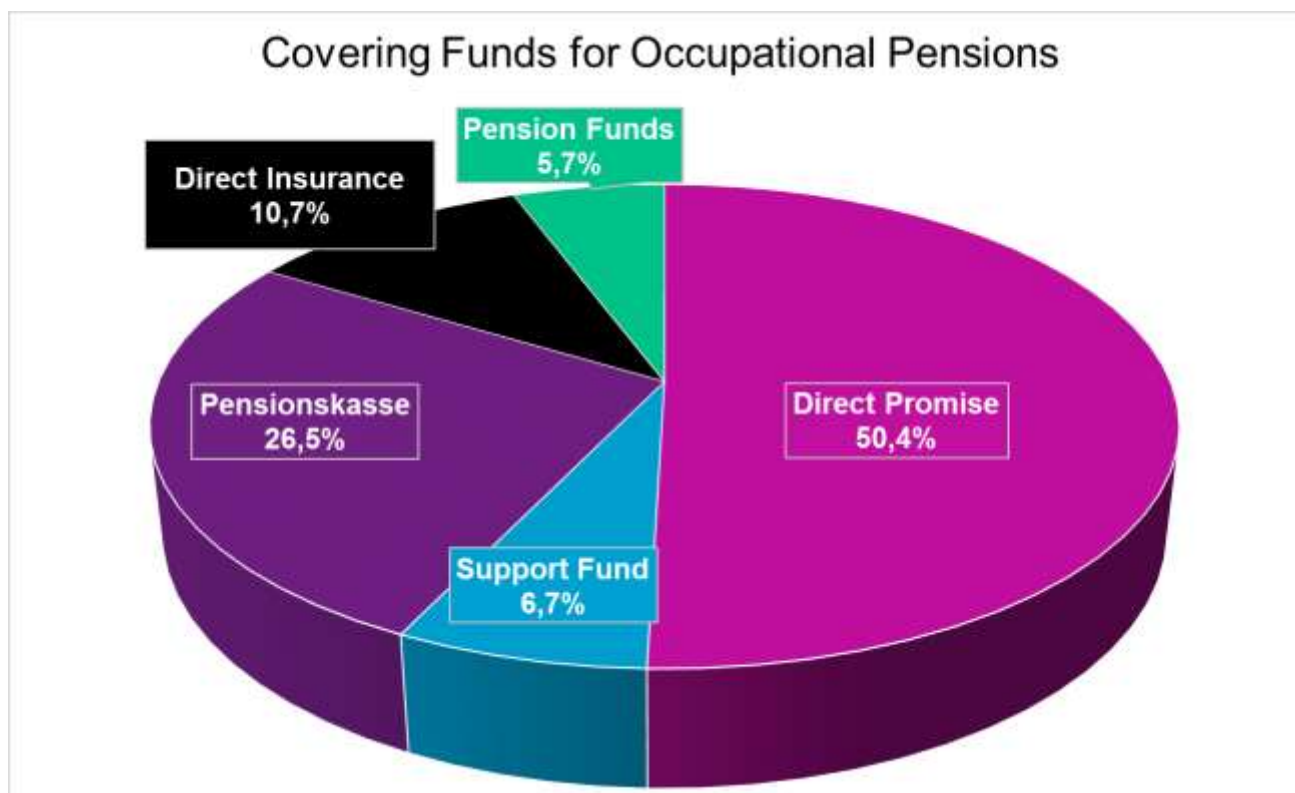
- **Traditional Defined Benefit** promises (salary related, flat amount benefits etc.) are in retreat – comparable to other countries.
- Contribution oriented **hybrid promises** and **cash balance** type plans are well established and increasingly popular.
- Typical promise includes benefits payable on **old age**, **disability** and **death**.
- Benefits mainly as **life-long annuities**, but **lump sum payments** and **installments** are possible and find increasing use.
- Employers are free to decide whether to offer an occupational pension scheme, but once introduced there is **mandatory co-determination** with works council.
- Benefit Promise is always given by employer, who also bears **final risk** in case any external vehicle used fails to pay promised benefits.



Some Statistics on Occupational Pensions in Germany

(1/5)

- Total covering funds at 31.12.2015: 575 Billion €
- Strongest growth is reported for Pensionskasse and Pension Funds



Source: Schwind J.
(2017)

Some Statistics on Occupational Pensions in Germany

(2/5)

- „Active covered“ employees with entitlement for occupational pension 2001-2015: (in Million [left axis] and in % of all employees covered by social security [right axis])

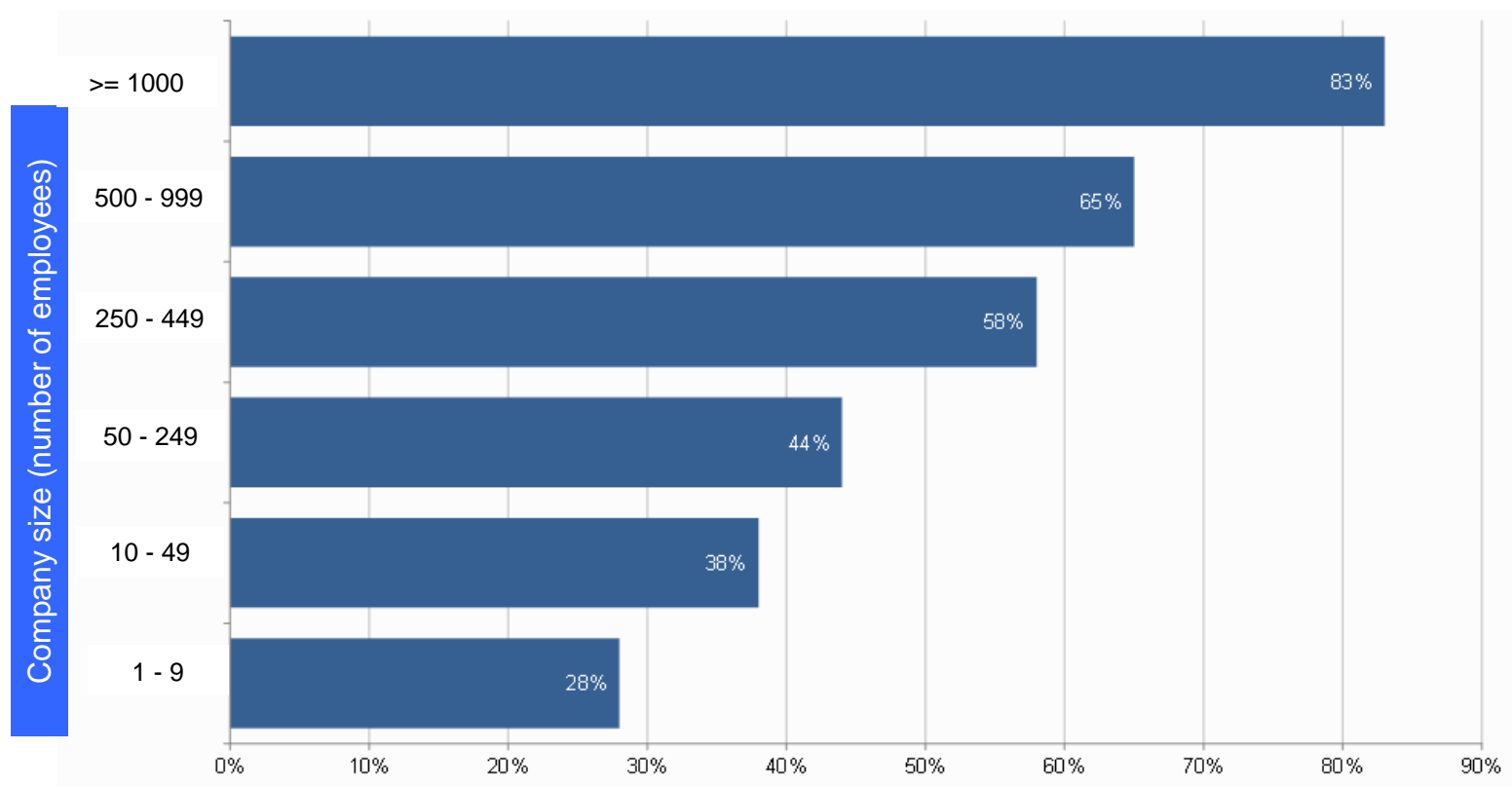


Source:
German
State
Pension
System
2017

Some Statistics on Occupational Pensions in Germany

(3/5)

- Employees with entitlement to occupational pension relative to size of company: (in % of all employees in the private sector)

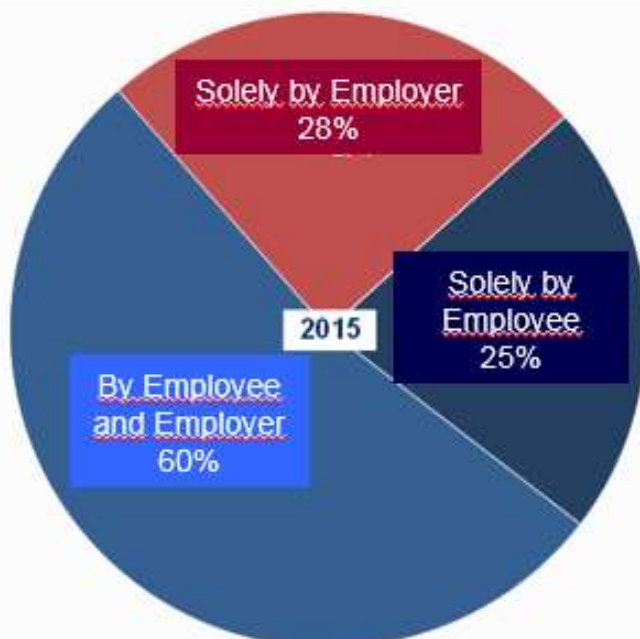
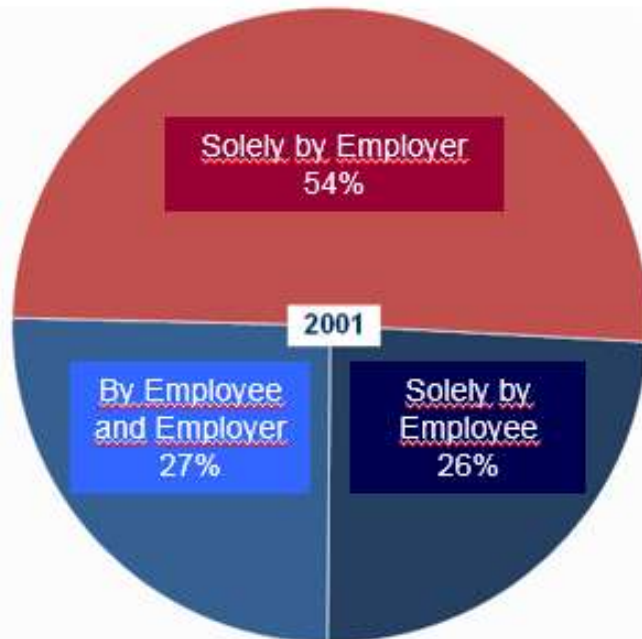


Source:
German
State
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System
2017

Some Statistics on Occupational Pensions in Germany

(4/5)

- Financing of occupational pension plans 2015 and 2001:
(in % of all commercial units in the private sector)

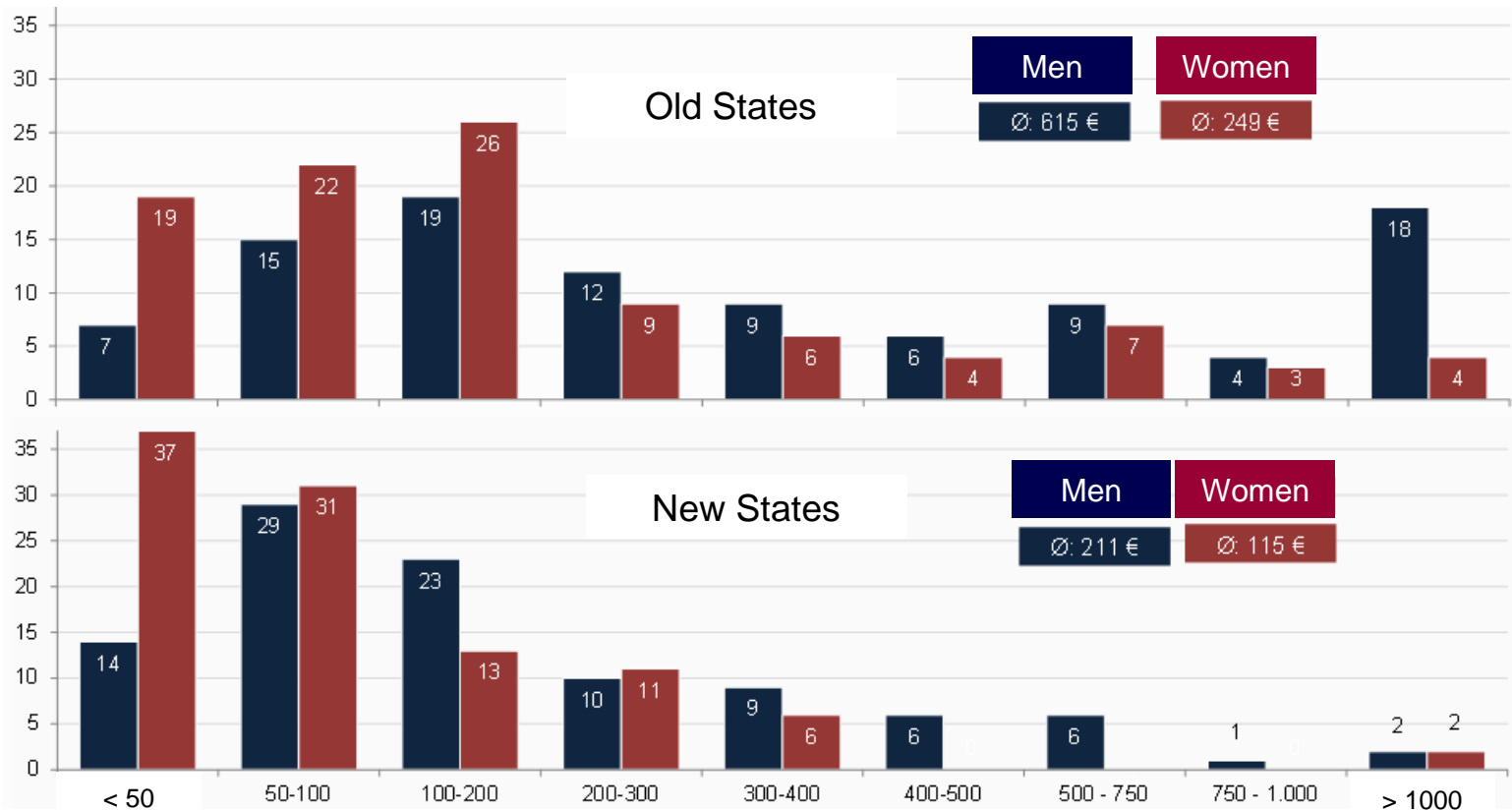


Source:
German
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2017

Some Statistics on Occupational Pensions in Germany

(5/5)

- Distribution of occupational pension entitlements 2015:**
 (monthly gross amounts in €, private sector, old and new states, in %)



Source:
German
State
Pension
System
2017

Occupational Pension Reform 2017

Last stop before compulsory company pensions ?

Situation in 2017:

- Social security pension not sufficient to fill pension gap.
- Company pensions should step in.
- But especially for small companies and low-income earners still uncommon.

2017: Law for “Strengthening of Occupational Pensions”

Commencement:
01/01/2018

Main aspects

DC plans by collective agreements

Opting out models

Increased limits on tax-favoured contributions to certain funding vehicles

Introduction of a new tax subsidy model for low-income earners

Employers have to pass saved social security contributions to employees in case of deferred compensation

Newly introduced DC plans by collective agreements

- Allow employers to implement **DC plans**
- **No minimum benefit or interest guarantees**
- Only permitted where the **underlying fund** is operated **jointly by unions and employers**
- Free to **enable** access also to **non-union employees**
- Financing vehicles must be **Pension Funds, Pensionskasse or Direct Insurance**
- **No lump sum benefits; only annuities** (except settlements)
- **No insolvency protection** via the PSVaG

Opting-out (automatic enrollment to Deferred Compensation)

- Allow collective agreement between employers and unions for **automatic enrollment** in company retirement plan under **salary sacrifice arrangement**
– but: the employee can opt out.
- Regulation can be extended to **non-union employees**

Only applicable for Pension Funds, Pensionskasse or Direct Insurance

Higher/dynamic income & Soc.Sec. tax free contributions

- Starting in 2018 a maximum of **8% of SSCC** (= 6,240 €, instead of previously 4% + fixed 1,800 €) are **tax free**
- Unchanged: 4% of SSCC are free of social security charges

Government support for low-income earners

- **Government support of 30%** for employer contributions between 240 EUR and 480 EUR p.a. **for low-income earners**
- Low-income = less than 2,200 EUR per month
- Only applicable to new promises or increases per 2018

Employers to pass on saved social security contributions

- Salary sacrifice arrangements: **employers have to pay saved social security contributions** (i.e. 15% of deferred pay) **into the employee's benefit account**
- Applicable for new pension promises in 2018 / 2019 and for existing promises in 2022 onwards

Questions ?



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