German Pension System

Experience and Challenges

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# Agenda

## Overview German Pension Landscape

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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

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

… 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

… 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  
… 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).

- **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“ (*Entgelpunkte*).
  - 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

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

  - Disability pension, Men, 0.881, 3.44%
  - Widow's pension, 4.704, 18.34%
  - Old-Age pension, Men, 8.072, 31.48%
  - Widow's pension, 4.704, 18.34%
  - Orphan's pension, 0.323, 1.26%
  - Disability pension, Women, 0.932, 3.63%
  - Old-Age pension, Women, 10.057, 39.22%

Total pensions: 25.645

Source: German State Pension System 2017
Some Statistics on German State Pension System

- 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 %

![Chart showing distribution of monthly old-age and disability pensions for Old States as of 31.12.2016, including percentages for different monthly pension brackets and gender distribution.]

Source: German State Pension System 2017
Some Statistics on German State Pension System

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

Forecast

Source: German State Pension System 2017

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Some Statistics on German State Pension System

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

Source: German State Pension System 2017
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** lead 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 „BVV“)

- 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*).
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

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

Source: Schwind J. (2017)
„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)

![Bar chart showing the percentage of employees with entitlement to occupational pensions across different company sizes.]

Source: German State Pension 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 State Pension System 2017
Some Statistics on Occupational Pensions in Germany

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

Source: German State Pension System 2017

Old States

- Women
  - < 50: 7%
  - 50-100: 19%
  - 100-200: 26%
  - 200-300: 12%
  - 300-400: 9%
  - 400-600: 6%
  - 600-760: 4%
  - 760-1000: 3%
  - > 1000: 4%

- Men
  - < 50: 15%
  - 50-100: 19%
  - 100-200: 22%
  - 200-300: 12%
  - 300-400: 9%
  - 400-600: 6%
  - 600-760: 9%
  - 760-1000: 4%
  - > 1000: 18%

New States

- Women
  - < 50: 37%
  - 50-100: 29%
  - 100-200: 31%
  - 200-300: 10%
  - 300-400: 11%
  - 400-600: 6%
  - 600-760: 6%
  - 760-1000: 1%
  - > 1000: 2%

- Men
  - < 50: 14%
  - 50-100: 23%
  - 100-200: 13%
  - 200-300: 10%
  - 300-400: 9%
  - 400-600: 6%
  - 600-760: 6%
  - 760-1000: 2%
  - > 1000: 2%

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”**

**Main aspects**

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<th>DC plans by collective agreements</th>
<th>Introduction of a new tax subsidy model for low-income earners</th>
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<td>Opting out models</td>
<td>Employers have to pass saved social security contributions to employees in case of deferred compensation</td>
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<td>Increased limits on tax-favoured contributions to certain funding vehicles</td>
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Commencement: 01/01/2018
### Main Aspects of new Pension Law (1/2)

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<th>Newly introduced DC plans by collective agreements</th>
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<td>Allow employers to implement <strong>DC plans</strong></td>
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<td>No minimum benefit or interest guarantees</td>
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<td>Only permitted where the <strong>underlying fund</strong> is operated <strong>jointly by unions and employers</strong></td>
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<td>Free to <strong>enable</strong> access also to <strong>non-union employees</strong></td>
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<td>Financing vehicles must be <strong>Pension Funds, Pensionskasse or Direct Insurance</strong></td>
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<td>No lump sum benefits; only <strong>annuities</strong> (except settlements)</td>
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<td>No insolvency protection via the <strong>PSVaG</strong></td>
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<th>Opting-out (automatic enrollment to Deferred Compensation)</th>
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<td>Allow collective agreement between employers and unions for <strong>automatic enrollment</strong> in company retirement plan under <strong>salary sacrifice arrangement</strong> – but: the employee can opt out.</td>
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<td>Regulation can be extended to <strong>non-union employees</strong></td>
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Main Aspects of new Pension Law

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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