PENSION PROVISION IN GERMANY – THE FIRST AND SECOND PILLARS IN FOCUS

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In August 2010, Germany's central bank raised its 2010 growth forecast for the German economy from 1.9% to 3% after GPD grew 2.2% in the second quarter, the fastest rate since 1991. Booming global demand for German products is fuelling the recovery and unemployment is down. Germany's leading business confidence index (Ifo) is presently at its highest level in two years. As Germany bounces back from the worst economic crisis in over 60 years, companies already face a skills shortage. This is focusing attention on how employee benefits — and employer-sponsored retirement plans in particular — can help attract badly-needed specialists, retain existing talent and increase overall employee motivation and satisfaction.

In this article, we'll look at the impact of pension reform on the first and second pillars over the last 10 years, as well as trends currently shaping the 2nd pillar environment. We'll also remove some misconceptions about the book reserve system, the predominant pension financing vehicle in Germany.

Roots of current system

Designed by Bismarck in 1889, Germany's public first-pillar system was the world's first formal old-age social insurance system.[1] It is still one of the strongest in the world, having survived two world wars, currency reforms and hyperinflation. In order to remove inflation risk, in 1957, the state pension was converted from a funded into a pay-as-you-go system. From its beginnings, the pension received from the state was designed to be an extension of the standard of living that had been achieved during one's working life.

Overview of key reforms since 2001

Germany has had a three-pillar pension system (according to the World Bank model) since 1974. Despite various reforms since then, costs have been rising steadily. As in many countries that face an aging population and lower birth rate, the math just doesn't add up. According to official figures, the proportion of the 65+ population to the working-age population (the dependency ratio) will double from 24% in 2009 to 50% in 2050. Germany already spends a relatively high amount on pensions: 11.4% of GDP compared with 7.2% for the OECD as a whole.[2]

[1] Börsch-Supan, Reil-Held and Wilke, "How an Unfunded Pension Systesm looks like Defined Benefits but works like Defined Contribution: The German Pension Reform," May 2007, Mannheim Research Institute for the Economics of Aging (MEA), University of Mannheim, p. 3
[2] Pensions at a Glance, 2009, Retirement-income systems in OECD countries

A turning point came in 2001 when a robust set of reforms strengthened the three-pillar system by lowering benefits from the first pillar and expanding the second and third pillars through tax relief and subsidies.

Given the rising dependency ratio, a key objective of the 2001 reform was to reduce the burden on younger and future generations by stabilizing the contribution rate to the public system to 20% of gross wages until 2020 (currently 19.9%) and 22% until 2030. This goal would be achieved as follows:

- The replacement rate for state pensions was reduced from 70% to 67% (based on a hypothetical 'standard' pensioner with 45 years of uninterrupted earnings history);
- To make up for the difference, the government introduced for the first time the concept of state-subsidized private retirement savings products;
- A new deferred compensation scheme was introduced. Employees earned the legal right to set aside up to a maximum EUR 2,640 (2010) toward an externally funded employer-sponsored retirement plan. This deferred compensation scheme is significant in the German setting because it is the only way to save for a supplementary pension from gross earnings.
- Pension funds were introduced as a new financing vehicle.

The 2005 pension reform introduced deferred taxation on pension income, aligning Germany to the European and international norm,and improved the portability of occupational pensions.

The latest reform was the increase of the retirement age from 65 to 67. This will be introduced gradually in 2012 and take full effect in 2029.

2nd pillar still plays minor role

Mainly thanks to deferred compensation arrangement, the number of people who have joined an occupational pension plan has increased (from 38% of employees in the private sector in 2001 to 51% in 2007[3]). At the same time, the creation of new purely employer-financed pension schemes — the standard during the 70s and 80s — has been close to nil since 2001. Instead, companies are increasingly turning to DC plans, many of which are co-financed by companies and employees (through matching contributions).

Despite improved conditions for occupational pensions, the second pillar still plays a minor role in Germany. In 2007, there were around 4.2 million people above the age of 55 (private + public sectors) receiving a supplementary pension from their employer.[4] Over 80% of a German's pension income comes from the state.

Distribution of pension income between pillars (in %)

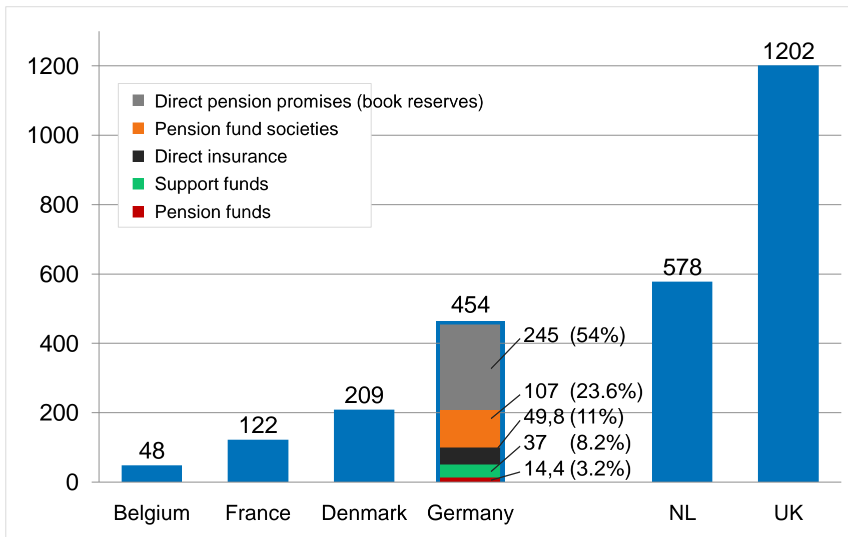
	Netherlands	Switzerland	UK	US	Germany	France
First pillar	50	42	65	45	85	79
Second pillar	40	32	25	13	5	6
Third pillar	10	26	10	42	10	15

Source: Xiaohong Huang (2010)/Borsch-Supan (2004)

[3] TNS Infratest, Sozialforschung
[4] According to ASID

Total pension assets in the German second pillar amounted to EUR 453.8 billion in 2008.[5] This, too, is relatively small compared to other European countries.

Size of 2nd pillar in selected European countries in EUR billion (2008)



Source: European Federation for Retirement Provision (EFRP), 2010 Annual Report, aba

Five ways to finance pensions

Although the German second pillar is small, many changes are currently happening within it, driven largely by the financial crisis and international accounting standards.

The German second pillar consists of two sub-pillars: direct pension promises and indirect pension promises. In total, there are five ways to set up corporate pension provision. Each method has very different functions and offers its own distinct advantages and disadvantages. Around 85% of MIttelstand companies — the small and medium-sized companies that form the backbone of the German economy — use a combination of vehicles.[6]

Book reserves – funded or unfunded?

The direct pension promise is the largest financing method. Under German accounting rules, pension reserves must be established on the balance sheet. The size of the book reserve system, accounting for 54% of all pension assets[7], makes Germany unique in Europe.

Direct pension promises are often wrongly interpreted outside Germany as being ‘unfunded’. This interpretation is incorrect from the perspective of an employee with a direct pension promise. The full (actuarial) value of pension promises must be shown as a liability in the balance sheet. As in any balance sheet, assets and liabilities must be balanced. However from a corporate view, it will not always be the case to have at any time enough liquidity to pay out pensions.

According to the German Working Group for Occupational Pensions (aba)
[6] Allianz, „Mittelstands-Studie zur betrieblichen Altersversorgung“, Juli 2010
[7] aba

Also contrary to the widespread perception, the book reserve system is safe. All companies that make a direct pension promise and build pension reserves must be a member of the Pension Insurance Association (PSV), which finances itself from contributions and pays out pensions in case of insolvency.[8] In the event of corporate insolvency, the employee is protected by law under the vesting arrangements (minimum duration of pension promise: five years; employee must be at least 25 when leaving the company or at the moment of insolvency).

Despite the existence of other methods for external pension funding, the internal book reserve system is still the simplest and usually most tax-effective method.[9] Building pension reserves has remained popular because it has always served as a cheap form of debt and an effective source of liquidity for the company.

Five ways to finance occupational pensions in Germany

*1. **Direct pension promise:** The employer is directly responsible for meeting the pension promise. The employer accrues for pension liabilities on the balance sheet and pays pensions from cash flow. Most companies insure their direct pension promises through an insurance company. All companies with direct pension promises must pay into the Pension Insurance Association (PSV).*

Indirect pension promises

2. Pension fund societies (Pensionskasse) - the second largest financing method. Pension fund societies are outsourced and legally independent entities. These can be used either for a single company or an entire industry sector. The Pensionskasse takes out an insurance contract for the employee and builds up capital from which the pension is paid. Pension fund societies are regulated by the Bafin, the German financial regulator. As a result, the employer is not required to pay into the PSV. Plan participants have a claim against the pension pool.

3. Support fund: Like pension fund societies, these are outsourced, externally-funded pension schemes. Unlike pension fund societies, employers must pay into the PSV as the plan participants have a pension claim against the corporation instead of the fund. A company can pay in almost unlimited amounts of contributions tax-free.

4. Direct/primary insurance: Companies take out an insurance contract directly with an insurer on behalf of the employee. The administrative burden is low and no PSV contributions are paid.

5. Pension funds ("Pensionsfonds"): Accounts for just 3.2% of total assets. Created with the 2001 reform as the fifth financing method to create an internationally recognized alternative to other financing methods.

Outsourcing of direct pension promises is rising

Despite the dominance of book reserves, international accounting standards have made pension risks more visible than they would under German accounting rules. Thus, although building pension reserves has been popular for a long time, companies that need to report according to International Accounting Standards (IAS) or US GAAP are practically forced to switch to externally financed

[8] The PSV had 76,029 member companies at December 31, 2009 covering around 10 million plan members (including 3.9 pensioners). The PSV contribution rate rose to a record 14.2% of pension liabilities compared to 1.8% in 2008 and 3% in 2007.
[9] Mercer.com, Raimund Rhiel, June 22, 2007

methods. As a result, more companies are looking to outsource their direct pension promises. Over two-thirds of DAX companies have already done so, while Mittelstand companies lag behind.[10]

A clear trend within the outsourcing of direct pension promises is using a combination of pension funds ("*Pensionfonds*") for holding past-service commitments and support funds for future service. These two types of financing methods are becoming increasingly significant. This is particularly true for companies that apply international accounting standards (such as GAAP or IAS 19), as direct pension promises that are not matched by direct funding on an accrual basis can reduce a company's credit rating. This in turn can threaten the company's ability to finance or refinance its activities.

While on the one hand, outsourced, indirect schemes are becoming increasingly significant in the case of new pension schemes, on the other hand, companies with direct pension promises are building up financial resources that are either pledged directly to the relevant employees or earmarked (in reinsurance policies) or are subject to a form of group pledge within a Group CTA (Contractual Trust Arrangement).

External financing of book reserves should also get a boost from new German accounting rules (BilMog) that went into effect as from 2010. In the past, German companies could calculate their pension liabilities using a 6% discount rate. The BilMog discount rate will be lower (currently 5.2%). For many companies, this will increase pension liabilities and make them look more volatile.

The shift to DC will continue

Employer-financed pension plans will increasingly be coupled with the deferred compensation scheme to make it more attractive for employees to participate and build up a supplementary pension (through matching).

The shift to DC is also putting more focus on how to design attractive executive pension packages. One reason is that benefits from the state system are capped. Furthermore, the maximum that employees can pay into an employer-sponsored pension scheme under the deferred compensation scheme (EUR 2,640 per year) is simply not attractive enough for many high-income executives.

A "new deal" between unions and employer associations

The "German miracle" of avoiding job cuts throughout the 2008/2009 global economic crisis was part of a responsible negotiation between employers and their employees, often supported by trade unions. With the economy now recovering, the increased need for specialists will once again lead to higher salary demands. The skills shortage in Germany is a long-term trend which is being exacerbated by the already shrinking working-age population. Using employee benefits as an HR and talent management instrument in the future will therefore become even more essential.

The pension reforms of the last decade will not be sufficient to ensure an appropriate standard of living in retirement for today's employees. The best solution would be to encourage further expansion of the second pillar. Deferred compensation arrangement is presently the only way for Germans to save for an additional pension from gross earnings. Occupational pensions are also subject to legal compensation for inflation.

[10] Allianz, 2010

Although employees are not obliged to sign up for deferred compensation, there is a need for them to do so. Employers should therefore be proactive in helping their staff to build up an additional pension. An occupational pension is a crucial building block in an overall compensation package. Both unions and employer organizations should be aware that current income will become less important and higher contributions toward old-age provision more important. The stability of the total future income needs to be a “fixed star” when considering potential trade-offs between employer costs and employees’ wages in the future.

Conclusion

Germany has a very complex system of occupational pensions. Yet it offers enormous flexibility and many possibilities for companies to create tailor-made solutions. New accounting rules, the impact of the financial crisis and the desire for plan assets with better liquidity have also increased attention for pension governance, pension risk management and derisking. In order to realize the full potential of occupational pensions, HR departments and employees need more tailor-made advice, education and information so that their companies can design the most appropriate employee benefits plans.

What we offer

The specialists of AEGON Global Pensions and our partners in Germany can help your company design attractive new employer pension plans and de-risk existing plans. We act as a single point of contact for multinational companies, providing access to a wide range of pension solutions and expertise around the world, including the **International Retirement Plan** for expatriates, derisking of defined benefit plans, **cross-border asset pooling** (available in Germany as from 2011), **Total Retirement Outsourcing** (TRO) in the US, and single- and multi-pension solutions. We can also help multinationals with headquarters in other countries that wish to include Germany as part of their international pension strategy.

HDI-Gerling, an AEGON Global Pensions partner in Germany, offers a wide range of external funding methods (reinsurance schemes, full reinsurance, partial reinsurance) and outsourcing solutions (pension fund for accrued rights, support fund for entitlements to be accrued, support fund for beneficiaries). It also provides advice on the impact of BilMog as well as labor and tax law on pension liabilities. It can help set up a CTA model.

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