The Occupational Pension Landscape in Germany

Last updated in May 2014
Overview

- Occupational pensions in the German retirement system
- Short history of occupational pensions in Germany
- The different vehicles (Durchführungswege)
- Occupational pensions in numbers
- Occupational pensions law: the benefit promise and insolvency protection
- Advantages of occupational pensions
- Challenges for occupational pensions
Occupational pensions in the German retirement system

Retirement provision

1st pillar
State pension
• mandatory for all employees who are subject to social insurance contributions
  • PAYG

2nd pillar
Occupational pension
• Voluntary or by tariff agreement
• Mostly funded
• EET taxation / incentives

3rd pillar
Personal pension
• voluntary
• encouraged through financial incentives (Riesterrente)
Short history of occupational pensions – Part I

- The concept of an employer sponsored pension fund goes back to the 16th century (miners). In the 17th century pension funds that covered clerics, teachers and public servants developed.
- One of the most famous actuarial valuations was performed by Carl Friedrich Gauss in 1845 for the Professors’ Widows and Orphans of the University of Göttingen
- Early funds offered dependant’s pensions, sickness benefits and funeral payments. Many were jointly administered by employers and members.
- 2nd period of proliferation during industrial revolution– movement away from professional schemes to company based schemes. Employer felt „duty of care“ to provide social benefits.
Short history of occupational pensions – Part II

- One of the earliest industrial funds was founded in 1812 by Peter Joseph Boch for his porcelain factory in Luxembourg, later to become the Villeroy & Boch workers fund
- During the 19th century many banks and insurance companies set up pension funds prior to the expansion of the industrial sector
- Precursor to modern day Pensionskassen was established in 1837 by a Bavarian spinning and weaving mill
- Similar institutions followed, Krupp (1858), Siemens (1872), Hoechst (1879), Degussa (1885), BASF (1887)
Recent developments

- 1974: Betriebsrentengesetz to protect occupational pensions
- 2002: Altersvermögensgesetz (Pensionsfonds, Beitragszusage mit Mindestleistung, limited EET for Pensionskassen und Pensionsfonds, Riester incentives)
- 2005: Alterseinkünftegesetz (new tax rules / framework)

Overall, there are only defined benefit and hybrid schemes in Germany. Pure defined contribution schemes are not considered to be occupational pensions under law (BetrAVG).
Occupational retirement provision encompasses all benefits which employers voluntary grant to their employees under their employment relationships through the five permissible vehicles for old-age, survivors’ or disability provision.

(Translated from Law on occupational pensions – Betriebsrentengesetz - Art. 1)
The different vehicles (Durchführungswege) – Part I

1. Pensionskasse
   - Under scope of IORP Directive
   - Assets segregated from sponsor
   - Beneficiaries have direct claim against assets

2. Pensionsfonds

3. Direct Insurance (Direktversicherung)
   - Outside scope of IORP Directive

4. Direct Pension Promise (Direktzusage)
   - Book reserve schemes
   - Assets not required to be separated from sponsor
   - Beneficiaries have no direct claim against underlying assets

5. Support Fund (Unterstützungskasse)

All are defined in the German Company Pensions Act, enacted in 1974 („Betriebsrentengesetz“, „BetrAVG“)
The different vehicles – Part II: Taxation and Prudential Requirements

<table>
<thead>
<tr>
<th></th>
<th>Pensionskasse</th>
<th>Direct Insurance</th>
<th>Pensionsfonds</th>
<th>Direct Promise (Book Reserves)</th>
<th>Support Fund</th>
</tr>
</thead>
<tbody>
<tr>
<td>Tax Effective Contribution Limits</td>
<td>Contributions tax effective up to 4% of social security ceiling [€71,400 Euro p.a. in 2014] + €1,800 p.a.</td>
<td>No upper limit for tax effective allocations to book reserves</td>
<td></td>
<td>Tax effective contributions severely limited unless fully reinsured, then no upper limit</td>
<td></td>
</tr>
<tr>
<td>Taxation of Benefits</td>
<td>Fully taxable (Certain amounts still tax-free due to grandfathering provisions)</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Own Funds</td>
<td>as per life insurance (approx. 5% of technical reserves)</td>
<td>none (except guarantee fund of €2.75m) if fund does not bear risk, otherwise as per life insurance</td>
<td>none</td>
<td>none</td>
<td>none</td>
</tr>
<tr>
<td>Investment Restrictions</td>
<td>Comprehensive catalogue of quantititative investment restrictions (eg. max. 35% risky assets). Qualitative risk management standards</td>
<td>Qualitative risk management standards                                             None</td>
<td>None</td>
<td>None</td>
<td></td>
</tr>
<tr>
<td>Underfunding</td>
<td>Not allowed</td>
<td>Up to 10% with 10 yr recovery period (5% if fund bears risk)</td>
<td>no funding by definition</td>
<td>no minimum funding requirement</td>
<td></td>
</tr>
</tbody>
</table>
Occupational pension vehicles in Germany

### Occupational membership 2001-2011 by vehicle

<table>
<thead>
<tr>
<th></th>
<th>2001</th>
<th>2003</th>
<th>2005</th>
<th>2007</th>
<th>2009</th>
<th>2011</th>
</tr>
</thead>
<tbody>
<tr>
<td>Direktzusagen und [Unterstützungskassen]</td>
<td>3.86</td>
<td>4.05</td>
<td>4.72</td>
<td>4.54</td>
<td>4.50</td>
<td>4.68</td>
</tr>
<tr>
<td>Direktversicherungen</td>
<td>4.21</td>
<td>4.16</td>
<td>4.08</td>
<td>4.18</td>
<td>4.34</td>
<td>4.72</td>
</tr>
<tr>
<td>Pensionsfonds</td>
<td>0.09</td>
<td>0.12</td>
<td>0.32</td>
<td>0.34</td>
<td>0.38</td>
<td></td>
</tr>
<tr>
<td>Pensionskassen</td>
<td>1.39</td>
<td>3.24</td>
<td>4.08</td>
<td>4.45</td>
<td>4.51</td>
<td>4.63</td>
</tr>
<tr>
<td>Öffentliche Zusatzversorgungsträger</td>
<td>5.11</td>
<td>5.39</td>
<td>5.33</td>
<td>5.16</td>
<td>5.06</td>
<td>5.17</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>14.56</strong></td>
<td><strong>16.91</strong></td>
<td><strong>18.33</strong></td>
<td><strong>18.65</strong></td>
<td><strong>18.75</strong></td>
<td><strong>19.58</strong></td>
</tr>
</tbody>
</table>

Occupational Pensions Law
The Benefit Promise

- **3 types of benefit promise:**
  - Traditional defined benefit (salary or career progression related)
  - Hybrid promises:
    - contribution oriented DB with an annual minimum return guarantee
      (beitragsorientierte Leistungszusage).
    - contribution oriented with minimum guarantee of sum of nominal
      contributions at retirement (Beitragszusage mit Mindestleistung)

- A benefit promise is **always given by an employer** (but may be
  financed/administered through an external vehicle).

- **True DC**, whereby the member carries all investment risk, is not
  allowed under the Occupational Pensions Law.

- Contributions can be in „cash“ to an external vehicle or „notional“
  if employer is using book reserves.
Occupational Pensions Law
The Benefit Promise

- Contributions can be financed by the employer or the employee through **salary conversion (Entgeltumwandlung)**

- All employees in Germany have a right to an occupational pension through salary conversion (**Riester reform 2001**)

- A benefit promise may include **benefits payable on old age, death and/or disability**. It may include a temporary pension that bridges the gap between early retirement (after age 62) and normal retirement.

- Not allowed are benefits payable in other events eg. temporary illness, early retirement prior to age 62, periods of care etc.

- **Due to tax reasons, lifelong retirement benefits mainly in pension form**, but lump sum payments are not forbidden

- Regardless of type of vehicle used, **employer is liable for the benefit that has been promised**.
PSV (Pensions-Sicherungs-Verein), Cologne

- Established 1974
- Extended coverage to **Luxemburg** employers in 2002
- Covers all **vested promises** (subject to ceiling) in book reserve, support fund and Pensionfonds schemes.
- **Ceiling** is €8.295 p.m. (Western States) and €7.035 p.m. (Eastern States) in 2014
- **Payment of pensions outsourced** to a consortium of 51 life insurers.
- Collects **annual levy** from sponsoring employers proportionate to the present value of accrued vested benefits.
Occupational Pensions Law
Insolvency Protection

- **Total levy covers:** Present value of claims w.r.t. pensions in payment arising in the year; Present value of increase in claims w.r.t. deferred entitlements in the year; Contribution to a fluctuation reserve; Contribution to a loss reserve fund; Admin costs

- The **levy can be smoothed** by
  - Accessing fluctuation reserve
  - Spreading contribution peaks over a 5 year period (used in 2009 for the 1st time)

- **Pensionsfonds** pay a reduced levy (20%) due to external funding and prudential regulation

- **Participating employers** (approx.): 93,000

- **Insolvency cases** since 2002 annually (approx.): 500-750
Advantages of occupational pensions for employees

Employees are **protected by social and labour law**, which stipulates that the employer has a **legal duty to make sure the pension promise is met**.

**Occupational pensions...**

- are often organised by the **social partners** (tariff agreements can achieve broad coverage)
- cover **biometric risks** such as longevity, death and/or disability
- **spread the risk**: in collective schemes, members share the investment risk
- **Diversify**: individuals not only rely on the state for their old age income
- **are good value for money**: employers can offer in-house solutions or negotiate collective agreements, which are often cheaper than individual contracts used for a personal pension
Challenges for occupational pensions

- Current **low interest rate environment**
- **Coverage** in Germany: around 60% (17m) of employees who pay social insurance contributions have an occupational pensions – this could be increased
- Review of the IORP Directive; EIOPA work on a „Holistic Balance Sheet“

**Occupational pensions and the crisis**

German occupational pensions have weathered the recent financial and economic crisis well – this is partly due to the protection mechanisms Germany has put in place:

- Protection of members and beneficiaries through social and labour law
- Legal obligation for the employer to ensure the pension promise is met
- Insolvency protection through the PSV