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German Pension Reform — A New Beginning

by Bruce Auchinleck and Hubert Mueller

Author's Note: This article summarizes the main points of German Pension Reform that will be effective from 1 January 2002, and the reasons for its introduction.

Why the Pension Reform?

Reasons for the introduction of German Pension Reform include demographic problems, and a desire to encourage private retirement provision.

Demographic problems

Introduced in the later part of the 19^{th} century by then Chancellor Bismarck, Germany has traditionally relied on a pay-as-you-go-system to fund generous state pensions. However, as in many other nations, pension financing in a pay-as-you-go system gets more difficult, the more unfavorable the ratio of contributors to retirees (contributor ratio). At present, this ratio is about 3:1 in Germany.

As a result of falling birth rates, rising life expectancy and changing employment patterns, it is estimated that the contributor ratio will fall to 3:2 by 2030, i.e., three workers will need to support pensions for two retirees by then.

Objectives of the Reform

There are two central objectives of the pension reform. First, the German government is planning to reduce the reliance on the existing system and supplement it with a fully funded private retirement provision. To that extent, the average state pension level will be lowered from the current maximum of 70% to 67% of pre-retirement income in the long term. Second, the German government wants to retain the total contribution rate* to the state pension system at less than 20% of social security earnings until 2020, and prevent it from rising above 22% by 2030.

** Payable 50% each by employer and employee*

Expectations

German pension reform is generally seen as a first step in the right direction. However, long-term contribution projections are based on highly optimistic assumptions and do not cover the two decades after 2030, when the demographic problems in Germany are expected to become most pressing. As a result, experts are warning that it will be impossible to stop the pension level from falling below 67% of pre-retirement earnings in the long run without exceeding the set maximum contribution rate of 22%.

Pension Reform Law

State sponsored private retirement provision

As with IRAs in the United States, people participating in the mandatory state pension system (civil servants and the self-employed are excluded) and unemployed persons are eligible to deduct voluntary contributions to an additional retirement plan from their taxable income, up to specified limits.

People with lower incomes will receive an annual state bonus, instead of the deduction of contributions from their income. State bonuses are the sum of basic bonus (per employee) and child bonus (per child).

Annual deductible contributions and state bonuses are defined in Table 1 below.

TABLE 1: ANNUAL TAX-DEDUCTIBLE CONTRIBUTIONS AND STATE BONUSES

Year	Tax-deductible	Basic Bonus	Child Bonus
2002	525 Euro	38 Euro	46 Euro
2003	525 Euro	38 Euro	46 Euro
2004	1,050 Euro	76 Euro	92 Euro
2005	1,050 Euro	76 Euro	92 Euro
2006	1,575 Euro	114 Euro	138 Euro
2007	1,575 Euro	114 Euro	138 Euro
2008+	2,100 Euro	154 Euro	185 Euro

Deductible contributions are defined to be the sum of voluntary contributions paid in the calendar year without allowance for any state bonuses. The maximum deductible contribution rises every second year from 1% of social security income in 2002 to 4% in 2008 and later years.

State bonuses will be reduced proportionally if the taxpayer doesn't pay the minimum voluntary personal contribution. These are defined as a percentage of taxable income in the previous tax year, subject to a prescribed minimum contribution.

The prescribed minimum annual contribution varies by marital status as follows:

- *No child:* 45 Euro in years 2002 to 2004 and 90 Euro from 2005
- *One child:* 38 Euro in years 2002 to 2004 and 75 Euro from 2005
- *More than one child:* 30 Euro in years 2002 to 2004 and 60 Euro from 2005

Qualifying Retirement Contracts

Qualifying retirement contracts need to fulfill the conditions listed in the "law on certification of retirement contracts." The most important requirements are:

- Benefits may not be paid prior to the earlier of attained age 60, the start of a disability pension payment or the start of the statutory retirement pension payment.
- Accumulated capital at the retirement start date must at least equal the total contributions paid during the term of the contract.
- A guarantee is included at outset that the payout mode after retirement is either a lifetime monthly annuity (level or increasing), or a payout plan up to age 85 (providing level or increasing monthly payouts), followed by a deferred payout annuity purchased by part of the capital available at the vesting date.
- Disclosure requirements regarding commissions paid, expenses charged and policy values illustrated (at point of sale and annually).

Expected impact on life insurance industry

In recent months, several organizations have made predictions on the future market potential generated by the German Pension Reform. These include:

- 35 million private pension accounts by 2008.
- An estimated premium volume of DM 86 billion (Euro 44 billion) by 2008 (see Exhibit 1).

Banks, mutual funds and insurance companies are all competing for a share of the private retirement contributions. Life insurers have somewhat of an edge over their competitors, given that they are used to providing life-contingent payout annuities. Optimistic predictions have life insurers' market share at around 60% of total contributions. Products are feverishly being developed right now, and some companies have started selling private pension plans already, even though they will not be effective until January of 2002.

Impact on product design

German Pension Reform is expected to have significant implications on life insurance product design such as:

- A movement towards products allowing flexible contributions;
- A movement towards simpler products with more transparent charging structures; and
- An introduction of products allowing flexible commission structures, including level commission products.

These implications suggest a contingent shift of life insurance sales towards unit linked annuity products. Currently, unit linked products already account for almost 30% of new life and annuity premiums (see Exhibit 2). However, most of the premiums to date have been unit linked life premiums. The expected increase in popularity of unit linked annuity premiums is also expected to attract a growing number of foreign players into the German life insurance market. The race for private retirement contributions has only just begun.

(Author's Note: Please refer to exhibits 1 and 2 on page 12.)

Bruce Auchinleck is a Consultant in the Cologne office (auchinb@towers.com) *and Hubert Mueller, FSA, is a Principal in the Hartford office* (muelleh@towers.com), *both with Tillinghast-Towers Perrin.*

(see table on page 12)

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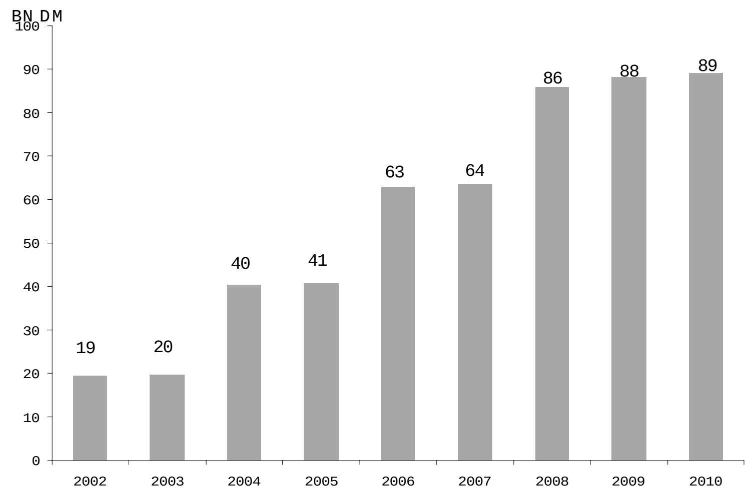
Exhibit 1

(DM - billions)

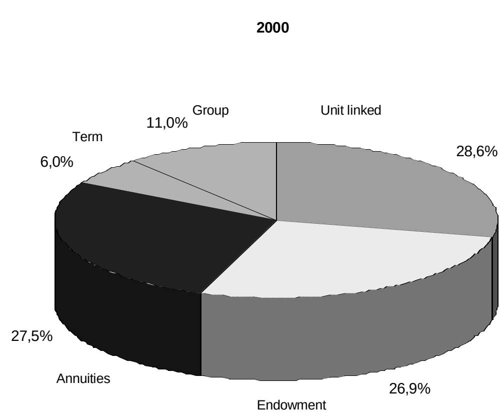
Estimated market potential



Source: Tillinghast Estimate

Exhibit 2

Market Share for Life /Annuity Products



* Based on new annualized premiums
Source: GDV; Tillinghast estimates