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What's New in Germany—Understanding CTA and Pensionsfonds

By Raimund Rhiel

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The company pension landscape in Germany is very diverse, both in terms of the level of provision and the way that companies finance their pension plans.

THE PENSION ENVIRONMENT IN GERMANY

A typical German company employee pension plan is designed around a considerably lower benefits target than plans in the United Kingdom, the United States, the Netherlands or Switzerland. German pension plan design historically has been mostly based on defined benefits, although the worldwide trend toward defined contribution is also increasingly evident in Germany.

Germany's pension finance/funding environment is radically different from all other major countries. German employers are not forced (or even encouraged) by labor or tax law to fund their pension obligations in an external pension fund. Although the law allows a range of funded approaches, 56 percent of all German pension obligations (that is, €250 billion of €450 billion) are instead financed by direct employer commitments in which the employer pays the pensions directly when they fall due. In case of insolvency there is a comprehensive protection system operated by the German Pension Protection Fund—*Pensionssicherungsverein* (PSV).

The employer has to accrue pension liabilities in its local and international financial statements. Very importantly, the employer can deduct unfunded accruals for pension cost from taxable income. The tax deduction is based on a statu-

tory methodology—the German *Teilwert*. This *Teilwert* is based on:

1. The entry age normal actuarial method
2. A discount rate of six percent and no allowance for future salary and pension (inflation indexation) increases.

Cost and liability determined in this way for a pay related plan are clearly “insufficient” when compared, for example, to the IAS19 or SFAS87 methodology, but the available deductions are generally more favorable than those allowed for by the various external pension vehicles (support funds, Pensionskassen, direct insurances and also reinsurance contracts for book reserve plans.) These approaches have suffered under less favorable tax rules (tax limits on funding or taxation as employee income) or insurance supervisory law with prohibitively high insurance premiums (based on an interest rate of 2.25 percent).

In the financial world the high incidence of unfunded pension liabilities among German companies reflects a major difference between the balance sheets of typical German companies and their Anglo Saxon counterparts.

The German perspective is that non German companies hide their pension liabilities in external pension funds.

The foreign perception of German companies is that they maintain unfunded or unsecured pension plans that are considered negatively by analysts and rating agencies.

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Ultimately, the economic reality is a bit different:

1. German plans are not unfunded, but are internally funded. Pension liabilities are fully recognized on the company balance sheet, and pension assets are integrated with the business assets.
2. German plans are not unsecured. They are strongly secured by business assets and reinforced by the mandatory insolvency insurance PSV financed jointly by all employers with pension plans.

In spite of the existence of several possible approaches for external pension funding, the fact remains that the internal book reserving system has continued to be the simplest and usually the most tax effective. All of the traditional German funding platforms suffer from a variety of limitations or impediments.

INTRODUCING THE CONTRACTUAL TRUST ARRANGEMENT

In the 1990s, German companies increasingly lobbied for the creation of new funding vehicles that were more tax effective. The official response was very limited and, as a result, companies like DaimlerChrysler and Siemens, both reporting under US GAAP, turned in 1999 and 2000 to the Contractual Trust Arrangement (CTA) as a platform for pension finance.

The CTA is fundamentally a very simple entity. The starting point is an internally or book-reserve funded program. As mentioned above, the pension assets are fully integrated with company business assets. A company may, however, choose to earmark certain business assets as being held to cover the pension liabilities.

The next step is then for the CTA to “ring fence” the earmarked assets by legally committing the assets to pension liabilities. The CTA is “the

fence,” or the legal framework that establishes the pension claim upon the assets.

The end result is company assets that are segregated and restricted for the purpose of pension benefit delivery. The art of CTA construction is a balancing act designed to achieve acceptance by both the employer and auditors, with the result that:

1. German tax law still recognizes the CTA assets as company assets to the extent needed to preserve the integrity of the book reserve tax benefits.
2. The applicable accounting standards (US GAAP or IFRS) recognize the CTA assets as substantive pension plan assets. This will also apply to the German (commercial) accounting standard (modernized German HGB standard) starting from Jan. 1, 2010, but still not under German tax law.

It is now quite well established that the balancing act is practical and possible, with CTA assets being recognized as plan assets (under US GAAP and IFRS, and in future German HGB standard).

The CTA, used in this way, provides a practical means whereby a German company can overcome the adverse perception of unfunded and unsecured pension liabilities in the international financial community.

A specific IAS 19 amendment in 2000 explicitly accepted CTA assets as plan assets, allowing netting against the pension obligation, and whose return volatility can be smoothed via the corridor approach.

This amendment triggered a rush among companies to establish CTAs, and this trend toward external funding of book reserve plans is still



“German company pensions are changing steadily to funded vehicles like (very flexible) CTAs or (a bit more regulated) Pensionsfonds in order to disconnect the pension plan’s fate from the company’s fate. In principle, that is a good thing despite the financial crisis!”

ongoing today. This is illustrated by the fact that most of the DAX30 companies followed DaimlerChrysler and Siemens in establishing a CTA: companies such as BASF, Commerzbank, Continental, Deutsche Bank, Deutsche Börse, Deutsche Post, E.On, Henkel, Infineon, Linde, Lufthansa, MAN, MunichRe, RWE and Volkswagen. The amendment of the German HGB standard, starting in 2010, will even accelerate this move towards external funding.

At the end of 2007, the pension obligations of the German DAX30 company groups amounted to around €211 billion and the plan assets to €150 billion, which resulted in a funding ratio of 71 percent. Due to the financial crisis in 2008 (and some changes in the DAX composition) the plan assets dropped down to around €125 billion. On the other hand due to increasing AA corporate bond interest rates in 2008 (and some changes in the DAX composition) the pension obligations decreased to €191 billion, so that the overall funding ratio only decreased to 65 percent.

Of course, those figures also include the non-German pension obligations of those DAX30 company groups. For the end of 2007 we estimate the non-German obligations to be around €60 billion and the corresponding plan assets to be around €62 billion. This results in a funding ratio of about 100 percent for the non-German obligations, whereas the funding ratio of the domestic German pension obligations of the DAX30 firms may be around 60 percent (plan assets of €88 billion versus pension obligations of €151 billion). We estimate that the vast majority of the €88 billion assets are CTA assets. The €88 billion DAX 30 domestic plan assets may have decreased in 2008 to €73 billion.

THE CTA SUCCESS STORY

Let us have a closer look at German CTAs and why they were and are so successful in Germany.

We already mentioned the traditional book reserve system’s attraction in terms of simplicity and tax effectiveness. The CTA provides a means of retaining the simple tax effective book reserve features, but with a similarly simple and effective enhancement allowing the company to operate the desired external funding policy.

Most important, the CTA can be established easily. The company does not need to have the consent of the employees—or the employee representatives in the workmen’s council. The employees still have their pension claims directly against the employer. Also, the tax treatment is unchanged for employees and employers: the employer funding the pension benefits in the CTA enhances security, which is positively perceived by employees.

The ultimate impact of the CTA is:

1. The program is now recognized as “funded” under IAS 19 and SFAS 87 (and, starting in 2010, also under German HGB standard).
2. The company can develop and operate the funding and investment policy that it believes most appropriate. It is easier to invest ring-fenced CTA assets as pension assets if they are separated from the company cash float.

There are no other consequences such as minimum or maximum funding requirements and no regulatory rules on investment or funding policy by any supervisory body.

Of course, well governed companies should have and do have governance rules guiding pension plan management. Such rules enhance good understanding and control of pension impact on the enterprise. This permits effective cash flow planning, professional asset allocation, investment process in general and con-

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trol of accounting risks (often value at risk approach) and so on.

Under German tax accounting rules a CTA is still classified as an unfunded book reserve plan, so that the company still pays the full insolvency premium to the German Pension Protection Fund of approx. 0.4 percent of German *Teilwert*, which may be approximately 0.3 percent of an accounting DBO in many cases. And the German *Teilwert* with a discount rate of six percent is used for tax-deductible pension expenses of the employer.

ALTERNATIVES TO CTA-BACKED BOOK RESERVE

In 2002, the German government established a new external pension vehicle, the *Pensionsfonds*. The new vehicle allows higher equity investments than allowed for insurance companies or *Pensionskassen*.

The market has been slow to take up the new vehicle mainly because the *Pensionsfonds* are more or less treated like insurance companies for regulatory purposes (heavy supervision and a very low discount rate of 2.25 percent).

At the end of 2005, the total assets of all 23 German *Pensionsfonds* (two company funds of Bosch and German Telecom, one industry wide multi-employer fund for the chemical industry and 20 commercial *Pensionsfonds* of insurance companies and banks) were still below one billion euros.

New legislative changes in 2006 have improved the situation for *Pensionsfonds*. They may operate with market interest rates (currently around 4.5 or five percent, which is roughly in line with discount rates under IAS 19 and SFAS 87). As a consequence, in 2006 and 2007 three company *Pensionsfonds* of Siemens, RWE and MAN were established, mainly to cover their current pensioners. Total assets of the 26 German *Pensionsfonds* at the end of 2007 rose to

15 billion euros, mainly due to those three company funds. In 2008 there was no major progress in the *Pensionsfonds*.

An advantage of the *Pensionsfonds* over the CTA-backed book reserve is that the premium for the German Pension Protection Fund is only 20 percent of the premium for book reserve plans. But there are still some disadvantages for active employees: (1) premiums for future service are limited to four percent of German social security ceiling (four percent of €64,800 is only €2,592 p.a.), and (2) there are some income tax disadvantages for active employees.

But for pensioner populations the *Pensionsfonds* has become an attractive competitor to CTAs. There are no disadvantages at all to the pensioners, and there are some advantages for the employer. But some regulatory asset allocation regulations (from Insurance Supervisory Authority, "BaFin") exist for *Pensionsfonds*, but not for CTAs. However, if the company's intent is to invest the assets prudently anyway (for example, in AA rated corporate bonds), then a *Pensionsfonds* for pensioners is very attractive. That is why Siemens created a *Pensionsfonds* for its current pensioners and transferred €6.4 billion in 2007 from its CTA to it. The assets for the active employees remain in the CTA. Also in 2007, German electricity giant RWE followed this line and transferred € 4.6 billion for its pensioners to its newly founded *Pensionsfonds*; similarly truck producer MAN with € 850 million.

Also, some of the 20 commercial *Pensionsfonds* of insurance companies and banks now use the higher flexibility in the premium calculation to offer competitive market products to attract employers (especially small and medium-sized companies) to transfer their pension liabilities to them. One insurance company (LV 1871) established its new *Pensionsfonds* in Liechtenstein in order to profit from Liechtenstein's more flex-

ible rules on the funding of deficits. But experts expect that the German rules on deficit funding will also improve.

CONCLUSION

Clearly, approaches to funding have been, and will continue to be active issues for German companies, both domestic and multinationals.

It also seems clear that any multinational with German operations would gain from working through the funding issues relative to their own local requirements and assets. □

International Section Council Activities at the 2009 SOA Annual Meeting

The 2009 SOA Annual Meeting will be held in Boston from October 25 to 28 and the International Section is sponsoring several activities.

Sessions

We are co-sponsoring two sessions jointly with the Financial Reporting Section on October 27. The first session, **The Convergence of Accounting Standards for Insurance**, explores what the convergence of US GAAP and International Financial Reporting Standards (IFRS) means for your work. The second session, **IFRS and Solvency Update**, will discuss the latest IFRS Exposure Draft on Insurance Contracts as well as various solvency initiatives worldwide. In addition we are sponsoring a session (also on October 27) on Microinsurance which will introduce the concepts of **Microinsurance** and provide examples of how it has been put into practice.

Reception

We will be repeating the successful International Section Reception that we held at last year's Annual Meeting. The reception will be held on October 27 from 6 pm to 9 pm and will feature delicious hors d'oeuvres, an open bar and karaoke. We hope you will be able to join us for a friendly evening of eating, drinking, singing and sharing experiences with your colleagues. The admission charge will be \$50 per person.